# THE ROLE OF THE FINANCIAL SYSTEM

# IN THE ECONOMIC DEVELOPMENT OF JORDAN

A THESIS SUBMITTED FOR

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## ABSTRACT

Jordan is a case of a developing country where priority has been given at the official level to domestic financial intermediation as one major instrument by which to attain the economy's development objectives. This policy preference conforms with recent trends in economic literature that emphasise the significance of financial institutions in economic development and the necessity of proper adaptation of these institutions, which were largely created prior to independence, to the particular post-colonial environment within which they have now to operate and to facilitate the required structural change.

The main objectives of this thesis are to analyse the structure and performance of the financial system in Jordan and examine whether its operations have been consistent with the country's development strategy. For this purpose, the study investigates three major areas of interest:-

(1) Analysing the structure and operations of different types of domestic financial institutions.

(2) Assessing their performance in the context of economic development, showing how well their activities have coincided with the defined development objectives.

(3) Specifying certain policies and procedures where financial innovation can take place to improve the operational efficiency of the system and to enlarge its contribution to real economic growth.

It is hoped that the particular issues identified as being of crucial importance for the Jordanian economy and the policy solutions put forward will be a contribution to economic knowledge of the role of the financial intermediation process in economic development.

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## ABBREVIATIONS

The following abbreviations have been adopted for convenience:-

| | |
|---|---|
| ACC | Agricultural Credit Corporation |
| AFM | Amman Financial Market |
| CBJ | Central Bank of Jordan |
| HB | Housing Bank |
| HC | Housing Corporation |
| IBRD | International Bank for Re-Construction and Development |
| IDB | Industrial Development Bank |
| IFC | International Financial Corporation |
| IMF | International Monetary Fund |
| JCB | Jordan Currency Board |
| JCO | Jordan Co-operative Organisation |
| JD | Jordan Dinar |
| MVLF | Municipal and Village Loans Fund |
| NBFIs | Non-Bank Financial Institutions |
| PCB | Palestine Currency Board |
| PF | Pension Fund |
| POSF | Post Office Savings Fund |
| SCIs | Specialised Credit Institutions |

PART A

# THE FINANCIAL SECTOR AND ECONOMIC DEVELOPMENT

## CHAPTER 1

### THE IMPORTANCE OF THE FINANCIAL SECTOR IN ECONOMIC DEVELOPMENT

Only comparatively recently have empirical and theoretical studies investigated the importance of the financial system in the process of economic development. The work of Gurley and Shaw, Goldsmith, and Cameron, constitutes the most prominent studies that have been done in this field of economic literature.(1) Their germinal work has given rise to a number of historical country case-studies, the results of which have significant implications for current development strategies in the less developed countries.(2) What therefore do these studies suggest, and what are their implications with reference to Jordan?

Historical evidence of financial development in developed countries reveals the existence of two distinct patterns of financial intermediation for the purpose of creating growth within a particular economy. On the one hand, institutions have played a leading role in economic development through direct involvement in the financing and promotion of industrial expansion. On the other hand, in some economies institutions have not per se been an engine of growth but have merely responded to the

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(1) See John G. Gurley and Edward S. Shaw, "Financial Development and Economic Development", Economic Development and Cultural Change, (April 1967); and Raymond Goldsmith, Financial Structure and Development (New Haven: Yale University Press, 1969); and Rondo Cameron and others, Banking in the Early Stages of Industrialisation (London: Oxford University Press, 1967); and Rondo Cameron, ed., Banking and Economic Development (London: Oxford University Press 1972). The recent work done by McKinnon and Shaw was also illuminating in this field. See: Ronald McKinnon, Money and Capital in Economic Development (Washington, D.C.: The Brookings Institution, 1973): and Edward Shaw, Financial Deepening in Economic Development (Oxford: Oxford University Press, 1973).

(2) See for example: Dimitrije Dimitrigevic, Money and Finance In Contemporary Yugoslavia (New York: Praeger Publisher, 1973); and Richard Tilly, Financial Institutions and Industrialisation in the Rhineland (Madison: The University of Wisconsin Press, 1966); Richard Rudolph, Banking and Industrialisation in Austria-Hungary (London: Cambridge University Press, 1976); and Ali Abdi, Commercial Banks and Economic Development, The Experience of Eastern Africa (N.Y.; Praeger Publishers, 1977).

emergent demand made for their services. Germany is often cited as an outstanding example of the former, whereas England is usually put forward as the prime example of the latter. In both types of case, however, the financial system has been successfully used for development purposes.(1) The difference in financial structure and development in both cases can be attributed to varying development needs, which accordingly necessitated different uses of financial institutions, and to the particular evolution pattern of forms of business organisation.

To take the English case first, here development of the financial system reflected, to a great extent, the characteristics of the early English industrialisation, with its emphasis on the textile industry.(2) As have been well documented, the industrial revolution in England was largely based on consumer goods industries, particularly textiles. The long-term requirements of such industries were comparatively small relative to their working capital needs, and were adequately met from accumulated profits within these industries.(3) Furthermore, the emergence of the joint-stock company as a mechanism for channelling savings for investment purposes, and the existence of stock exchanges facilitating the transfer of the financial assets they created, tended to circumscribe the importance and areas of influence of the financial institutions as suppliers of capital. In such circumstances the main task of the English financial system was to provide short-term credits and to satisfy any current financial requirements of various industries. By these means, the English financial system became well adjusted to the special needs of its economy and thereby facilitated real economic growth. As Habakkuk puts it:

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(1) Richard Tilly, op.cit pp 7 - 12

(2) Ibid, p. 7

(3) Ibid

> ".....financial institutions adapted themselves to meet the principal economic needs of their period and English banks concentrated on the provision of working capital because that was what industry needed; if there had been a large unsatisfied demand from industry to finance fixed capital, financial institutions would, with relative ease, have adapted themselves to meet this need, or new institutions would have arisen for the purpose." (1)

On the other hand, economic and financial development in Germany during the nineteenth century was different to that of England during the early phase of its industrial revolution. Here, the relative absence of joint-stock companies and an emphasis on railway investment and other related productive activities (such as mining and metal working concerns which needed large requirements of capital formation) influenced the structure and operations of the financial system. As these capital needs exceeded available voluntary savings and the accumulated profits within these industries, they had to be financed by financial intermediation. Consequently, the German financial system coped with these needs by an active initiative in and extensive provision of short-term and long-term financial assistance and advice, thereby creating direct-growth inducing effects on domestic industrialisation.(2) Indeed banks were said to have assisted industrial enterprises from the cradle to the grave.(3)

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(1) H.Habakkuk, American and British Technology in the Nineteenth Century (Cambridge: Cambridge University Press, 1962) p.175. Reported in Sidney Pollard, "Fixed Capital in the Industrial Revolution in Britain", The Journal of Economic History (Sept. 1964) p.308.

(2) Richard Tilly, op.cit., p.12

(3) Richard Randolph, op cit. p.2

One main conclusion to be derived from such historical financial experience in England and Germany, as well as from the experience of other developed countries, is the existence of a variety of successful types of financial systems designed adequately to serve the particular context in which they operate.(1) Rondo Cameron concluded his comparative study of the evolution of banking systems in eight developed countries by confirming that the historical record of banking evolution showed an absence of a single model of the banking system appropriate for all economies.(2) Countries are widely different in their culture, social, political and economic circumstances and these accordingly impose different constraints, requirements, and responsibilities on their financial systems. Today's developing countries should therefore seek to benefit from the historical financial experience of their antecedants, failures as well as successes, and apply what they consider appropriate for their special circumstances. Adherence to inappropriate operational criteria inherited from a colonial past, or a slavish imitation of financial systems operating in different economic and financial environments are to be rigorously avoided. The financial systems in these countries must adopt policies, procedures and pursue institutional innovations that are consistent with their development objectives. The adjustment problem of the financial system demands an increasing interest in these countries which are experiencing structural changes in their economies to achieve the set development objectives. The financial system has a crucial role in facilitating and promoting the required infrastructural changes.(3) In realisation of this fact,

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(1) Scotland and Japan have also been considered as countries where the financial system was successful during the economic development. See Cameron, Banking in the early stages of Industrialisation, op. cit. P.290.

(2) Ibid. P.318.

(3) The channels through which financial intermediation can induce growth in the real economy are discussed later in this chapter.

many developing countries have given priority to the development of financial institutions as an important instrument for attaining the selected goals of domestic development programmes. This has been particularly encouraged by the recent literature that emphasised the significant interaction between financial and real growth during the course of economic development, as shown below.

The issue of the extent to which a country's financial system influences real economic growth has been a controversial one in recent years. Numerous theoretical and empirical studies emphasised the existence of a close and positive relationship between finance and real development. This view was mainly held by Adelman and Morris, Goldsmith, Wallich, Cameron, McKinnon, and Shaw.(1) The empirical studies of both Goldsmith and Wallich are of special importance in providing quantitative supporting evidence of the existence of this relationship.(2) In studying the financial structure and development of 35 developed and developing countries, Goldsmith reached the conclusion that a country's financial superstructure is closely connected with its real infrastructure.(3)

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(1) See: Irma Adelman and Cynthia Morris, "An Econometric Model of Socio-Economic and Political Change in Underdeveloped Countries", The American Economic Review (December 1968); R. Goldsmith, Financial Structure and Development, op.cit; H. Wallich, "Money and Growth, A Country Cross-Section Analysis", Journal of Money, Credit and Banking (May 1969); R. Cameron, Banking in the Early Stages of Industrialisation, op.cit; R. Cameron, Banking and Economic Development, op.cit; R. McKinnon, Money and Capital in Economic Development, op.cit; E. Shaw, Financial Deepening in Economic Development, op.cit.

(2) Adelman and Morris also tried to empirically establish a statistical explanation for the economic and noneconomic forces that directly and indirectly determine a country's capacity for economic growth. Although their analysis of financial intermediation was only one aspect of a variety of socioeconomic and political variables included in their model, the results obtained by this work further contributed to the positive role of the financial sector during the course of economic development. Using data covering 74 developing countries, they found that among all variables having impact on growth potential, the degree of improvement in financial institutions came first in order of magnitude. See Adelman and Morris, op.cit. P.1206.

(3) R. Goldsmith, op.cit. PP. 372-390.

Wallich reached a similar conclusion using a country cross-section analysis including 43 developed and developing countries. He found that the degree of financial intermediation was significantly and positively related to real economic growth.(1)

Gurley's work supports the opposing view that the development of financial institutions does not necessarily accompany growth in the real economy.(2) He states that financial institutions are not an essential condition for economic development.(3) His view is based on the fact that financial intermediation is only one among several other institutional techniques which a country may adopt to influence real growth. In addition to financial intermediation, there are other close substitutes for mobilising and allocating resources for development, such as central planning and fiscal policies. The choice among these alternatives depends on the social costs and benefits of each. Thus, if a country follows one of these options other than financial intermediation, the financial system may not have an important impact upon economic growth. Countries can, therefore, achieve high rates of economic development without necessarily attaining parallel high levels of financial intermediation.

Despite Gurley's theoretical analysis which gives doubt to the significance of financial intermediation in the course of economic development, the majority of economists who have studied this area agree that both finance and real growth are closely connected.(4)

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(1) H. Wallich, op.cit. P.302

(2) J. Gurley, "Financial Structures in Developing Economies", in Fiscal and Monetary Problems in Developing States: Proceedings of the Third Rehovoth Conference, ed. David Krivine (New York: 1967) PP. 99-116.

(3) Ibid; and Gurley, J. "Review of Banking in the Early Stages of Industrialisation, ed. Rondo Cameron", American Economic Review, (September 1967) PP. 950 - 53.

(4) See footnote No. 1,P.5 and: A. Abdi, op.cit. P.14; R. Porter, "The Promotion of the Banking Habit and Economic Development", Journal of Development Studies, (1966) no. 4, P.347.

Nevertheless, even among this group there is still little agreement on two major matters: firstly, the unequivocal establishment of the direction of this causal relationship, and secondly, agreement on a clear-cut and recognised method or indicator for measuring financial development. These two points need further clarifications.

(a) The causal nexus of the relationship between financial development and real growth.

The empirical investigations of the previously mentioned authors reveal that changes in the real sectors of the economy are accompanied and facilitated by parallel changes in the financial sector. Economic development is characterised by an increase in the role of the financial instruments and requires diversified financial and specialised institutions to meet the growing and more sophisticated needs of the economy. However, whether it is financial development that induces economic growth, or vice versa, is still not clear. Although it is largely held that growth in the real economic sectors usually induces and stimulates financial development,(1) it is sometimes difficult to distinguish clearly the direction of the causal relationship between the two changes. Theoretically, the causality of the relationship may be explained in both directions; economic growth can induce financial development and financial development can also promote growth. Economic growth can induce development in the financial sector through two main channels; firstly, as economic development progresses, potential savings are expected to increase as a result of rising incomes. Secondly, the process of economic development also influences the quality and quantity of investment opportunities. Naturally, more savings and greater investment opportunities created in the economy encourage and induce a parallel development in the financial sector. As far as the financial influence on real economic growth is concerned, the way the financial system adapts itself to the particular needs of its economy and the efficiency by

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(1) R. Cameron, Banking in the Early Stages of Industrialisation, op.cit. P.1.

which this system performs its functions can effectively stimulate real economic growth. This influence will be revealed later when discussing the economic implications of the role of the financial system.

However, the interpretation of the nature of the causal relationship between economic and financial development is necessary in order to explain whether the financial system in a given country has a passive or positive role during the course of economic development. The answer to this question must largely depend on the evolutionary pattern of the financial system, i.e. whether it is a 'demand-following' or 'supply-leading' financial system. The demand-following financial system develops in response to the demand for its services by investors and savers in the real economy.(1) As an economy grows, additional demand for financial services are generated, which accordingly creates a supply response in the growth of the financial system. That is, the demand for financial services creates its own supply. In this case, financial services (as compared with real capital) are considered as a passive and only permissive factor, rather than a factor of production.(2) The supply-leading financial system, on the other hand, means the creation of financial institutions and the supply of their services in advance of demand for them, especially the demand of entrepreneurs in growth-inducing sectors.(3) In this case, the financial service is created independently and not in response to the demand side. By channelling resources from traditional (non-productive) sectors, and by direct finance and promotion of the entrepreneural response

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(1) H. Patrick "Financial Development and Economic Growth in Underdeveloped Countries", Economic Development and Cultural Change, (January, 1966) P.174.

(2) R. Cameron, Banking in the Early Stages of Industrialisation, op.cit. P.1.

(3) H. Patrick, op.cit. P.175.

in growth-inducing sectors, the financial system can play an active developmental role, since it represents an opportunity to induce and encourage new investments to take place, and thus promote economic growth by financial means.(1)

However, it should be noted here that even if the financial system is of the demand-following type, an adequate adaptation of this system to the growing needs that emerge during the course of economic development is necessary to facilitate the required changes in the real economy. Experience shows that the financial system is not,however, neutral with respect to economic development.(2) Economic development demands some infrastructural adjustments in real economic sectors in a way consistent with the defined development objectives. This necessitates an adequate adaptation in the financial sector to facilitate and bring about the required infrastructural changes. Failure in this respect would undoubtedly result in retarding the development in real infra-structure. As a generalisation, it can be said therefore that the structure of the financial system, and the way the system reacts and responds to the special needs of its economy, may well hasten or retard the process of economic development.(3)

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(1) Ibid, p. 176.

(2) R. Cameron, Banking and Economic Development, op.cit. p.24. This is also the theme of Shaw's book which emphasises that the financial system does matter in economic development: See E. Shaw, Financial Deepening in Economic Development, op.cit. p.3.

(3) R. Cameron, Banking and Economic Development, op.cit, p.8 and D. Dimitrijevic, Money and Finance in Contemporary Yugoslavia, op.cit. p.5.

(b) Methods and concepts for measuring financial structure and the degree of financial development.

The term 'financial structure' implies ratios and relationships that characterise the components of the overall financial system and tie it to its economy.(1) Changes in the financial structure of a given country over time reflect the stage of financial development that the country reached. Countries are widely different with regard to their financial structures and the ways their structures have changed and adapted themselves to real infrastructural adjustments. These differences can be attributed to different economic rates of growth, the degree to which the financial system penetrates the economy, and the speed and adequacy of financial adaptation.(2) Differences in financial structures among countries imply the existence of stages in a cycle of financial development, as reflected in changes in the quantitative and qualitative relations between the size and character of the financial structure and financial transactions, on the one hand, and of the infrastructure of national wealth and national income on the other.(3) Financial structure and development, therefore, can be measured by relating financial magnitudes to comparative economic quantitatives.

The literature, at present, provides a variety of methods and ways for measuring financial structure and thus distinguishing different stages of financial development. Despite this variety, however, all these methods show a systematic pattern and a reasonable degree of regularity in financial development that takes place as the economy

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(1) R. Cameron, Banking and Economic Development, op.cit. P.9.

(2) Raymond Goldsmith, Financial Structure and Development, op.cit. P.5.

(3) Ibid.

undergoes development. These measures, as shown below, illustrate that during economic development, countries usually experience more rapid growth in financial assets than in national wealth or national income. This phenomenon can be related to the rapid monetization of the subsistence sectors of the economy and the substitution of bank liabilities for commodity money.(1) When non-monetized sectors of the economy are drawn to market-oriented production, the financial function has to service larger proportions of the economy.(2) As economic development takes place, greater specialisation and division of labour in production (and consumption) require more financial transactions between various economic units, thus leading to rapid financial growth in relation to real economic development.(3) The rising trend of financial development is not, however, a process that continues without limit.(4) Empirical evidence reveals that once an advanced stage of development is attained, rapid financial growth gradually tapers off.(5) This is also the case in the financially matured economies which are experiencing the same financial/real growth ratios which they used to have many decades ago. Gurley and Shaw relate this phenomenon to the fact that the space of monetization exceeds the space of real growth in diminishing degrees.(6) At an advanced development stage, when various economic sectors are becoming almost fully monetized, and as business firms are more able to supply their financial needs

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(1) Rondo Cameron, Banking in the Early Stages of Industrialisation, op.cit. P.307.

(2) _____, Banking and Economic Development, op.cit. P.204.

(3) Ibid.

(4) Raymond Goldsmith, Financial Structure and Development, op.cit. P.44.

(5) Ibid. P.45; and Cameron, Banking and Economic Development, op.cit. P.204.

(6) Gurley and Shaw, "Financial Development and Economic Development," op.cit. P.259.

from their own resources, relatively less financial transactions in relation to real output are required.

Although the existing literature provides a variety of concepts and methods for measuring financial structure and the degree of financial development, two main approaches deserve special interest[1]: the adoption of a particular method depends basically on the precise purpose of the study, and the availability of the required statistics.

1. The "Goldsmith Approach". In measuring the degree of financial development, Goldsmith relates a country's financial superstructure to its real infrastructure as reflected in the financial interrelations ratio. This ratio can be obtained by dividing the total value of the financial assets that exist in a community at one date by the total value of tangible assets plus net foreign balances, i.e. by national wealth.[2] Goldsmith's empirical study shows that the financial interrelations ratio has a tendency to rise during the course of economic development because the financial superstructure in a country grows more rapidly than its real infrastructure.[3] Developed countries, as his study reveals, have much higher financial interrelations ratios

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(1) Moreover, Rondo Cameron developed the concept of "banking density" as a crude index of financial development. This measure of density relates bank offices to total population. The actual index is constructed as follows:

$$\frac{\text{No. of bank offices} \times 10{,}000}{\text{Total Population}}$$

Cameron defines a ratio over 1.0 (that is more than one office per 10,000 inhabitants) as "high"; between 0.5 and 1.0 as "moderate"; below 0.5 as "low"; and below 0.1 (i.e. one office per 100,000) as "very low". See R. Cameron, Banking in the Early Stages of Industrialisation, op.cit. P.297.

(2) R. Goldsmith, Financial Structure and Development, op.cit. P.27.

(3) Ibid. P.44.

than those prevailed in less developed countries. His study shows that this ratio continues to rise until a certain stage of development is attained, then it levels off. This occurs once the ratio reaches a value between 1 and $1\frac{1}{2}$, as experienced in Western Europe and North America early in the twentieth century.(1) The U.S.A. has been cited as an example for this phenomenon, where the financial interrelations ratio is still at about the same level it reached fourty years ago (1.27).(2) On the other hand, the present value of the financial interrelations ratios of less developed countries averages between one and two-thirds, similar to those reached and then surpassed in the more developed countries during the second half of the nineteenth century.(3) The financial interrelations ratio therefore can be used to measure and compare the degree of financial development attained by a country.

2. The "McKinnon Approach". McKinnon relates the monetary liabilities of the community to its total real output.(4) This can be obtained by dividing M2 money supply (including time and saving deposits as well as M1) by GNP. McKinnon considers this method as the simplest way for measuring changes in a country's financial structure over time, and comparing different financial structures that exist among countries at different stages of their financial development. What distinguishes this from the Goldsmith approach is the simplicity and wider availability of the necessary required statistics, on both the regional and the universal sides.(5) In developing countries in particular, the

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(1) Raymond Goldsmith, Financial Structure and Development, op.cit. P.45.

(2) Ibid. P.340.

(3) Ibid. P.45.

(4) Ronald McKinnon, Money and Capital in Economic Development, op.cit. P.91.

(5) M2 and GNP figures required by this method can be easily obtained from the International Financial Statistics published by the IMF.

statistics required by this method (i.e. M2 and GNP) are usually more obtainable than that required by the previous measure (i.e. aggregate financial assets and national wealth). This is especially the case in Jordan where the published financial statistics do not comprehensively cover the whole financial sector. As will be shown in Chapter 9, there is a particular lack of statistics pertaining to the activities of insurance companies operating in the country. For this reason, it therefore seems impractical to try to apply Goldsmith's approach to the Jordanian case.

Despite the above advantages of the M2/GNP ratio, it is important to note that this measure does not provide a comprehensive picture of domestic financial development; it only reflects the degree of intermediation[1] by the monetary system as represented by the central bank and the commercial banks. In this respect, Goldsmith's approach has an advantage over this measure since it covers the intermediation by the whole financial system. Despite this weakness, however, it is generally believed that the M2/GNP ratio can be used as a broad index of the degree of financial intermediation in developing countries, where the liabilities of the monetary sector account for the bulk of financial assets.[2] Given the fact that, in most of these countries, financial institutions other than banks are either non-existent, or are still of little importance in the financial structure, it seems

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(1) Financial intermediation and financial development are two terms of one concept revealing the degree to which the financial system penetrates in the economy.

(2) See: H. Wallich, op.cit. P.294; H. Engberg, "The New African Central Banks and Monetary Management", In Financial Development and Economic Growth, Arnold Sametz, ed. (New York: New York University Press, 1972,) P.197; R. Bhatia and D. Khatkhate, "Financial Intermediation, Savings Mobilisation, and Entrepreneurial Development: The African Experience", IMF Staff Papers, (March 1975) P.138; and A. Abdi, op.cit. P.68.

reasonable to use the ratio of money and near money to GNP as a broad index of financial intermediation - i.e. the extent to which non-financial sectors of the economy hold part of their wealth in the form of financial assets.(1)

Having analysed the close interrelation between financial and economic development, it is necessary now to examine the precise ways and mechanisms whereby the financial system can influence real economic growth. This will be shown by an investigation of three principal functions that the financial system can, or should, perform in a growing economy.

1. The Intermediation Role. The financial system plays a vital role in carrying out and facilitating the saving-investment process, through its intermediation between the sources of funds and their ultimate users. In the first place, the financial system serves as a reservoir of the accumulated funds of the community. It mobilises the savings and idle funds of those who have an income surplus in excess of their current requirements. Those surplus units are large in number and varied in character, ranging from individual personal savers to different economic sectors. It is the responsibility of the financial system to adopt and devise adequate means and instruments through which it can satisfy the varied needs of savers and mobilise their surplus funds. Mobilising funds is only one aspect of the twin-intermediary role of the financial system. Equally important is its role in utilising these funds among competing investments. This allocative function is particularly important in order to achieve the required infrastructural changes implied by development programmes. Economic development

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(1) In developing countries, generally, holdings of currency, demand deposits, time and saving deposits (i.e. M2) constitute the bulk of financial assets; whereas other forms such as government securities, corporate shares, and contractual savings are still relatively insignificant in private asset portfolio.

emphasises the necessity of channelling sufficient resources into certain priority sectors which are necessary for attaining the overall development objectives. This is an important area in which the financial system can participate in economic development, as ceteris paribus, the more efficient the allocation of financial resources in accordance with domestic development strategies, the higher will be the rate of economic growth and the greater will be the contribution of the saving-investment process (through financial intermediation) to economic development.

The above intermediary function would suggest that the financial system can indirectly stimulate growth in real output through its influence on increasing the aggregate volumes of saving and investment and improving the allocation pattern of investable funds in accordance with development needs. By offering a wide array of financial assets of differing degrees of security, liquidity, yield, etc., an efficient financial system can substantially institutionalise and increase the aggregate savings available for investment.(1) Such a financial system can also stimulate and encourage larger investment to take place. Since intermediaries are able to tap enormous amounts of savings and can also diversify their risks among alternative outlets, they are more able to providefunds at lower cost than would prevail in the case of direct individual financing.(2) Even if financial intermediation does not imply a reduction in the cost of borrowing, the availability of funds from the financial system enables investors, who used to suffer from the lack of adequate finance, to enlarge their investment undertakings.(3) Clearly, reducing the cost of borrowing and/or increasing

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(1) Gurley and Shaw, Money in a Theory of Finance, (Washington D.C.: The Brookings Institution, 1960) P.55.

(2) H. Wallich, op.cit. P.295; and E. Furness, Money and Credit in Developing Africa, (London: Heinermann Educational Books Ltd. 1975) P.19.

(3) H. Patrick, op.cit. P.184.

the availability of finance are important incentives to larger investments, thus giving an important development impact of the financial system.

2. The Credit-Creation Function. A second outstanding function of the financial system is mainly confined to one major group of financial institutions only - the commercial banks. What distinguishes commercial banks from other financial institutions is that they act not only as intermediaries, but also have power as creators of credit through their own operations on the basis of the fractional reserve system.(1) This privilege, results from their unique position among financial institutions; given to them by the fact that their demand deposits liabilities are widely accepted as money and thus furnish a substantial portion of the effective domestic money supply. Bank deposits are book entries resulting from the crediting of deposits (currency as well as cheques) and the proceeds of loans and investments to customers' accounts. These deposits can be increased by extending loans and investments so long as the required cash reserves ratio is maintained. This distinguishes commercial banks from other financial institutions which merely act to mobilise funds from various sources and then allocate these funds to different assets.(2) The significance of money creations,

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(1) R. Cameron, Banking and Economic Development, op.cit. P.7.

(2) The distinction between commercial banks and non-bank financial institutions (NBFIs) has been a controversial issue in recent years. Culbertson, Aschheim, and others maintained the "traditional view" that commercial banks are unique in the process of credit creation and they can alone create loanable funds, whereas NBFIs can extend credit only after a prior act of saving. On the other hand, Gurley and Shaw, among others, adopted the "new view" that NBFIs are essentially similar to commercial banks in that they can also generate a process of credit-creation through their own operations. The latter economists argued that although NBFIs cannot create money in a technical sense because their liabilities do not serve as a means of payments (like the commercial banks), nevertheless, these institutions are able to create the particular types of financial claims which are close substitutes for money. In so doing, NBFIs can also expand the supply of loanable funds through extending loans and investments. However, despite these opposing views, our concern here is to emphasise the fact that the financial

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from the economic development point of view, is that commercial banks could make funds available to finance larger investments in excess of what it could be financed from current savings.(1)

3. The Direct Promotion and Financing of Industrial Development. A third possible function of the financial system is the provision of entrepreneurial talent and the financing of technical and industrial innovation.(2) This function differs from the previous two functions in that it has a direct developmental impact, whereas the other functions can only stimulate economic growth indirectly. Direct growth-inducing effects can come about by the provision of initiative, guidance, feasibility studies, as well as finance for the creation and expansion of industrial and other productive ventures.(3) Such promotional activities can be carried out by specialised financial institutions which are usually created, with government support, to encourage certain priority sectors which have a direct influence on development. However, the historical evidence of banking evolution in many countries has shown that even the commercial banks could play a leading role in financing technical innovation and the long-term requirements of industrial expansion.(4)

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bt/fwd... system, or at least its commercial banking institutions, can considerably assist development by supplying the community, through credit-creation, with larger amounts of investable funds above that which could be available from current savings. For more details of the above controversy, see D. Fand, "Intermediary claims and the adequacy of our monetary controls", In: Banking and Monetary Studies, Deane Carson, ed., (Homewood, Illinois: Richard Irwin, Inc. 1963) P.238.

(1) However, any excessive use of this power of money creation may create inflationary pressures which usually have unfavourable impact on economic growth.

(2) R. Cameron, Banking and Economic Development, op.cit. P.7.

(3) Ibid.

(4) As shown earlier, Germany and Japan are cases in point. See PP. 2-3

Summary and Conclusions.

The preceding discussion has demonstrated that both historical evidence and theoretical analysis suggest that the financial system can play an active promotional role in instigating and manipulating the course of economic development. The issues that have been raised above will now be examined in the context of Jordan in the light of five main levels of enquiry:-

(1) Development strategy:

What are the development strategies that have been adopted in Jordan, and what role has been officially assigned to financial institutions to help in attaining the set development objectives?

(2) Financial Intermediation:

How far has financial intermediation in Jordan proceeded with economic growth? What degree of financial development has Jordan so far attained? Did financial development occur with price stability or was it accompanied by price inflation?

(3) Financial and Economic Development Interaction:

What is the nature of the operational linkage between economic development and the development of domestic financial structure? That is, did the process of economic development stimulate the growth of the financial structure, or was the provision of financial services responsible for promoting real development?

(4) The Nature of the Evolution Model:

The above question leads the study to enquire whether the country's financial institutions are of the 'demand-following' or the 'supply-leading' type, and how does the pattern of evolution influence the development in the real economy?

## (5) A critical assessment of the Financial Policies Adopted:

What was the actual role played by the financial system in promoting economic development and to what extent has its activities been consistent with the defined development strategies? Did the financial system play a growth-inducing role which has been shown possible? If not, how can it be made to play such a role?

Before this analysis can properly be attempted, however, it is necessary to establish the historical experience of Jordan by, first of all, (Chapter2) examining the nature of the inheritance of the colonial monetary experience and the resultant behavioural constraints and blockages that remained during the first years of political independence; and secondly (Chapter 3) by establishing the initial and subsequent pattern of financial intermediation and economic development that occurred after independence. These are two important parameters within which future policies and achievements of domestic financial institutions must have relevance if new policies are to be effective in creating significant structural change.

# CHAPTER 2

## THE FINANCIAL INHERITANCE AND IMPLICATION OF THE JORDANIAN COLONIAL PERIOD

The evolution of the financial system of many developing countries was initiated during a colonial period in their history, which significantly shaped its operational characteristics and biased its operational activities towards the promotion of external rather than internal investments. This developmental bias was consistent with the then prevailing interest of economic policy in these countries, which concentrated on promoting complementary economic and trading ties between them and their metropolitan centres, whereas little attention was actively paid to their industrial autonomous needs. Once political independence was achieved, the requirements of a new autonomous development programme and the promotion of internal activities within a coherent indigenously chosen framework demanded a radical re-allocation of financial resources to remove this bias. However, the possession of de jure executive freedom of action tended to be inhibited by traditions and attitudes inherited from the colonialist past, due to administrative inertia and lack of indigenous expertise. As a result, countries were unable to realistically identify a new post-independence structural plan for economic activity. Jordan is a particular example of a financial re-adjustment problem which still remains, despite more than three decades of political independence as has been shown in my M. A. Thesis.(1) The present thesis attempts to identify the precise role of the financial system in economic development and the ways and methods by which this system can participate effectively in promoting the Jordanian economy. The M. A. Thesis reached the following six specific conclusions about the process of banking evolution, which

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(1) Salah, J.; The Evolution of the Banking System in Jordan M. A. Thesis (The U.K. : Keele University, March 1977)

will furnish an adequate background to this study[1] -

(1) AN IMPORTANT PRE-CONDITION FOR ECONOMIC STABILITY AND AN APPROPRIATE ENVIRONMENT CONDUCIVE TO BANKING DEVELOPMENT IS THE INTERNAL INTEGRATION OF THE CONSTITUENT PARTS OF THE COUNTRY UNDER THE AEGIS OF SOME FORM OF NATIONAL CENTRAL POLITICAL CONTROL:

Jordan suffered more than most countries before independence from changes in the administrative colonial centre of control, and after independence from territorial changes that radically altered its geographical boundaries and largely influenced its financial system.

In the period prior to 1946, as the smaller state of Transjordan, it was economically and financially linked to Palestine under administrative control first from Turkey and subsequently from Britain. Both Palestine and Transjordan were under Turkish rule from the beginning of the sixteenth century to the end of the first World War.[2] With the Turkish defeat in this War, the United Kingdom was granted (in accordance with the San Remo Conference of the Allied Powers held in April 25th 1920[3]) the mandate for Palestine and Transjordan. The British Mandate came into effect on September 29th 1923 and terminated in 1946.[4] Two years after independence, the 1948 Arab-Israeli War resulted in the creation of Israel out of the geographical area of Palestine, followed in 1950 by the establishment of the Hashemite Kingdom of Jordan to include both Transjordan (subsequently referred to as the East Bank) and the remaining part of Palestine which was left in Arab hands after the War (and thereafter known as the West Bank.) The Second Arab-Israeli War of 1967 further

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(1) The following conclusions were based upon the analysis of banking development during the period since the Colonialist era up to 1975. After this year, however, the financial system exhibited further response to the country's development needs. See Chapter 11 of this thesis. PP.348-349.For the above conclusions, however, see J. Salah, The Evolution of the Banking System in Jordan. op.cit. PP. 116-123.

(2) Robert Nathan & others, Palestine: Problem and Promise, An Economic Study (Washington, D.C. : Public Affairs Press, 1946) P.48

(3) Sa'id B. Himadeh, Monetary and Banking System of Syria, (Beirut: American University of Beirut, 1935) P.61

(4) The Mandate over Palestine was ended in 1948. See R. Nathan & others, op.cit P.62

resulted in the West Bank of Jordan being occupied by Israel. All these vicissitudes in political control and geographical area throughout the Jordanian history took place within the space of fifty-five years. Needless to say, such events helped to retard the internal development of the country.

The above political changes were accompanied by parallel developments in the financial sphere. During the period of Turkish rule, Transjordan and Palestine had been subsumed under the Turkish monetary system, their domestic currency being the Turkish gold pound, the currency of the Ottoman Empire. With the British occupation of both countries, the Turkish currency was withdrawn from the market and replaced by the Egyptian pound, rigidly fixed to the pound sterling.(1) The Egyptian pound was recognised as legal tender up to November 1st. 1927, when the Palestine Currency Board (PCB) was established to issue an independent monetary unit for Palestine (the Palestine Pound). Immediately after its introduction in Palestine, the Palestinian pound was declared legal tender in Transjordan as from December 7th. 1927.(2) The Palestinian pound continued to be legal tender in Transjordan up to July 1950, when the Jordan Currency Board was finally established to issue an independent monetary unit - the Jordan Dinar - for the Hashemite Kingdom of Jordan. Thus, during the British Mandate Period, Transjordan was a satellite area within the Palestinian monetary system. This monetary dependence paralleled overall economic dependence on Palestine. The latter was a major market for Transjordan's exports and an important supplier of its import needs. On average, about 94%of Trans-jordan's exports was exported to Palestine during the period 1937 - 1944,

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(1) Sa'id Himadeh, op.cit. P.50

(2) A. Konikoff, Transjordan, An Economic Survey. (Jerusalem: Economic Research Institute of the Jewish Agency for Palestine, 1946) P.86

whereas about one fifth of her imports came from Palestine.(1)

The Arab-Israeli War of 1967 left adverse effects on the Jordanian economy and its financial system. As a result of the War and the consequent occupation of the West Bank of Jordan, the economy was deprived of 40% of its GNP which had originated from this area. The banking system was seriously affected by this War and its aftermath. All bank branches situated in the occupied West Bank were completely closed.(2) This situation immediately resulted in considerable losses in bank resources and severely limited bank activities. The banks, while they had to gradually repay customers' deposits as agreed with the Central Bank of Jordan, failed because of the political circumstances to collect their credit extended in the West Bank, incurring severe losses. By 1975, commercial banks had paid out about 90% of their deposits liabilities to West Bank residents, while they had only received 13% of their total credit extended there.(3) The occupation of the West Bank also deprived the banks of one of their previous sources of deposits. In May 1967, i.e. a month before the War, the relative share of the West Bank in total bank deposits was 31%.(4) Furthermore, a large area of credit extension in the West Bank became no longer available. The proportion of credit extended in the West Bank in total bank credit in May 1967 comprised about 23%.(5) Such events adversely influenced bank operations in the East Bank of Jordan, as reflected in the slow growth of the network of bank branches; only one bank branch was established in the East Bank in the year following the 1967 War.(6)

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(1) Ibid. PP. 66-67

(2) Bank branches in the West Bank of Jordan accounted for 27. See Chapter four of this thesis, table 4.5.

(3) & (4) & (5) The Central Bank of Jordan, Banking Control Department (Unpublished data).

(6) See Appendix 4.3 of this thesis.

## (2) THE COLONIAL EXPERIENCE BROUGHT ABOUT CHANGES IN THE FINANCIAL SYSTEM THAT WERE BOTH PROGRESSIVE AND YET INHIBITED THE EVOLUTION OF A NATIONAL FINANCIAL INFRASTRUCTURE APPROPRIATE FOR DOMESTIC ECONOMIC DEVELOPMENT.

The banking history of Transjordan essentially began in 1925, with the domestic establishment of the Ottoman Bank,(1) one of the largest colonial banks operating in the Middle East. The early presence of this foreign bank gave a stimulant to other domestic banks to start operations in the country. It was the Arab Bank, that was established in Palestine in 1930, which followed the example of the Ottoman Bank in extending its activities to Transjordan; it opened two branches there, one in Amman in 1934 and the other in Irbid in 1943.(2) As a result of the Palestine War and the establishment of Israel in 1948, the head office of the Arab Bank was moved to Jordan. The introduction of banking activities, where effectively there had been none before, together with the setting-up of the PCB to issue a monetary unit for Palestine and Transjordan, constituted an essential step towards monetizing the economy, a necessary pre-condition for economic development.

Despite this advantage, however, monetary subjugation resulting from Currency Board control of monetary affairs and banking operations put the economy in a strait-jacket of dependency. During the British Mandate Period, both Palestine and Transjordan were monetarily dependent on the U.K. In this context, their monetary system operated in accordance with the "Sterling Exchange Standard" which applied to other British colonies. According to this system, the issue of local colonial currencies

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(1) Dr. Abdul Malik, "Commercial Banking in Jordan", The Bankers' Magazine, (November 1966), P.331.

(2) Central Bank of Jordan, Banking Control Department, (unpublished data).

was undertaken by an authority often called "Currency Board".(1) The PCB acted as the agency for the operations of the Sterling Exchange Standard and the issue of domestic currency. Issues of Palestinian pounds were made against sterling deposits placed in London. By this mechanism, an automatic link was established between the Palestinian pound and sterling. Sterling convertibility meant that the PCB was always ready to buy and sell Palestinian pounds at a fixed parity against sterling surrendered in London. These sterling reserves were invested on the London Money Market. Accumulated sterling investment served also as backing for the Palestinian currency outstanding. Thus the monetary dependence on the U.K. manifested itself in a rigidly fixed par value between the Palestinian pound and the sterling, on the basis of 100% sterling cover for the Palestine currency issued.

Although such Colonial monetary arrangements had some domestic advantages, in the sense of providing a sound local currency, involving an absolute guarantee of full and free convertibility into sterling at a stable rate of exchange, it had on the other hand a serious retarding impact on internal economic development.(2) The PCB was unable to adopt an independent monetary policy to suit domestic economic requirements. It was a dependent monetary institution with headquarters in London, the members of the Board were appointed by the British Secretary of State for the colonies.(3) It was represented in Palestine by a currency officer (the treasurer) and a foreign commercial bank (Barclays Bank). The Board acted purely automatically as a money changer, without discretionary powers to practise any type of official domestic monetary policy. The adoption of the Sterling Exchange Standard in Palestine and Transjordan was, in fact, to promote the economic and trading ties with the U.K. and to finance

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(1) W. T. Newlyn, "The Colonial Empire", in Banking in the British Commonwealth, R. S. Sayers ed. (Oxford: Clarendon Press, 1952) P.423

(2) Edward Nevin, Capital Funds in Underdeveloped Countries, (London: Macmillan & Co., Ltd., 1961). P.8.

(3) A. Konikoff, op.cit. P.86

British War expenditures in the Middle East. The full and automatic relationship between the Palestine pound and sterling meant that the more sterling and British Treasury Bills surrendered to the PCB in London, the more Palestinian pounds could be issued and submitted to the Mandate authorities to meet their local expenditures. The standard system was not, therefore, designed to promote internal innovation and mobilisation of funds for domestic development purposes. On the contrary, it constituted a major drain on national resources, since the requirements of the 100% sterling cover of local currency led to immobilisation of a considerable part of the country's savings in the form of sterling assets invested abroad.

(3) WHILE EFFICIENT ALLOCATION OF CAPITAL IS GENERALLY PRESUMED TO RESULT FROM CAPITAL MOBILITY MOTIVATED BY THE MARKET MECHANISM, COLONIAL EXPERIENCE WOULD SUGGEST, AS INDEED THAT OF JORDAN DEMONSTRATES, THAT INSTITUTIONAL INFRASTRUCTURE IS CRUCIAL AND CAN BIAS DOMESTIC CAPITAL ALLOCATION AND SEVERELY LIMIT THE SUPPLY OF BANK CREDIT FOR DOMESTIC USE.

During the period of the British Mandate, the Banking system of the country adhered to the general pattern of the colonial banking system, which was generally characterised by the dominance of foreign banks. British overseas banks (colonial banks) spread throughout the Colonial Empire to facilitate and finance the needs of both Britain and colonial territories. In Palestine,(1) for example, three principal colonial banks were responsible for holding about four-fifths of total deposits.(2) The dominance of foreign banks largely influenced the general characteristics of the banking system and biased its operations towards external, rather than domestic activities. The colonial context in which this system had to operate created the following four operation biases -

(a) <u>A distinct bias towards investment abroad</u>. Given the operational strait-jacket of the Currency Board System, the PCB was precluded by law from pursuing any type of banking or demand management functions.

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(1) During the British Mandate period, internal banking statistics for Transjordan were not available.

(2) Robert Nathan and others, op.cit. p.307

Commercial banks were therefore left free to choose their investment portfolios. Due to the absence of adequate domestic investment outlets acceptable to the banks, together with the significance of the City of London as a banking centre where additional funds were always demanded, the London Money Market naturally absorbed the bulk of the colonies' surpluses. As a result, large proportions of domestic deposits were, in effect, re-deposited in various sterling investments in London. During the period 1937-1945, about half of Palestine's deposits was transferred abroad through the operations of the banking system. Such a situation was natural in the absence of any control on bank activities. Colonial banks operated as branches of an international banking system, transferring funds from one area to another to satisfy differing credit requirements as they arose. Only one single balance sheet was published by these banks, showing the aggregate assets and liabilities, regardless of the origin of deposits. These banks were thus in a similar situation to other branches of the same bank operated in a metropolitan country. They were functioning as if they were part of the United Kingdom's banking system, giving a similar situation when the Currency Board System made the colonies part of the monetary system of the United Kingdom.(1)

(b) A Preference for maintaining a markedly high level of liquidity in domestic banking. This was partly due to the limited opportunities for domestic investment and partly to the fact that these banks, being mainly British overseas banks, had their special conservative operational criteria which severely minimised their internal activities. These banks brought with them their traditions and attitudes which they used to follow in their home country.(2) For instance, in extending credit to local

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(1) E. Nevin, op.cit. P.45; and W.T. Newlyn, op.cit. P.438.

(2) E. Nevin, op.cit, P.48; and Newlyn & Rowan, Money and Banking in the British Colonial Africa, (Oxford: Clarendon Press 1954) P.94.

potential borrowers, the banks required a high standard of credit worthiness and a conventional collateral security which they usually used to ask for. Few indigenous enterprises were able to provide the type of conventional security and to cope with the high standard of credit worthiness. In addition, in keeping with the British tradition in banking practice, colonial banks restricted themselves mainly to short-term assets and self-liquidating loans.(1) Given the development needs of colonial territories, what they really needed were long-term credit facilities for financing newly established industries. All these conservative operational attitudes resulted in minimising the volume of domestic bank activities, and thus maintaining a high percentage of bank funds in a liquid form.

(c) An institutional bias towards the financing of the foreign trade sector at the expense of domestic agricultural and manufacturing activities. Since colonial banks were originally established to facilitate the economic and trading ties with the United Kingdom, it was not surprising that their operations were mainly confined to those activities which served this purpose. Therefore, credit extended to the foreign trade sector constituted the bulk of total bank credit, whereas the requirements of the domestic agricultural and manufacturing sectors were not adequately met. This situation was worsened by the lack of any domestic government backing which would make bank credit available for these sectors. Furthermore, the inability of the Currency Board System to foster the development of specialised credit Institutions added to the difficulty of these sectors to obtain adequate finance.

(d) The development of bank activities was confined almost exclusively to previously established centres of trade and commerce, depriving rural areas of basic banking services. As these banks concentrated their activities on the financing of the foreign trade sector, the bulk of their transactions was carried out in the main commercial centres. As a result, commercial banks maintained branches only in the big cities in which well-established enterprises existed. There was no economic incentive for the

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(1) H. A. Gunasekera, "Banking Arrangements in Ceylon," in Banking in the British Commonwealth, op.cit. P. 46.

banks to extend their services into the rural and deeper areas of the country. The colonial banking system was therefore characterised by low branch density in relation to total population.(1)

(4) COLONIAL TRADITIONS AND PROCEDURES CONTINUED TO EXIST OVER SOME 14 YEARS ONCE POLITICAL INDEPENDENCE WAS ACHIEVED, AND DURING WHICH THE COUNTRY REMAINED MONETARILY DEPENDENT ON THE UNITED KINGDOM UNDER THE CURRENCY BOARD SYSTEM. THIS SITUATION FURTHER RETARDED THE PROSPECTS AND ABILITY TO SET-UP AND ACHIEVE AUTONOMOUS DEVELOPMENT OBJECTIVES AND TO IDENTIFY THE WAYS IN WHICH THE BANKING SYSTEM NEEDED TO CHANGE TO FACILITATE THIS PROCESS.

Even when Transjordan did achieve independence in 1946, the Palestine pound continued to be its domestic currency until the setting-up of the Jordan currency Board (JCB) in 1950, and the subsequent issue of an independent national domestic currency. Despite political independence, Jordan continued to be monetarily dependent on the United Kingdom throughout the period of the JCB which ended in 1964. Although the members of the Board were appointed by the Jordan Council of Ministers, it was managed and directed by British experts. Its headquarters were situated in London, and represented in Amman by a currency officer. Three out of the five members appointed to the Board were British, one of whom was the chairman, whereas the remaining two were Jordanian, one representing the Jordanian Government and the other was representing the largest domestic bank, i.e. the Arab Bank.(2) This situation prevailed until 1957, when the Board's headquarters were transferred to Amman and new members of the Board were appointed.(3) Four of the five members appointed were now Jordanians, with the Minister of Finance being Chairman, and the remaining member was British. However, although the Board's headquarters were moved to Amman, this procedure did not, in practice, result in any significant change in

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(1) W. T. Newlyn, "The Colonial Empire", op.cit. P.449.

(2) Jordan Currency Board, Report for the period 20th July 1949 to 31st March 1951 (London: 1951), Appendix A Law No. 35 of 1949, P.1.

(3) Jordan Currency Board, Report for the Year Ended on 31st March 1958, (Amman: 3rd August 1958) P. 2.

the operational characteristics of the JCB. The Board followed its precedent the PCB and continued to adhere to the basic features of the Sterling Exchange Standard: maintaining a stable rate of exchange between the Jordanian dinar and the pound sterling on a one-to-one basis, and keeping a full sterling cover of the Jordan currency issued invested in London. Holding any proportion of the currency cover in domestic assets was prohibited by Law, thus precluding any possibility of a fiduciary issue.

One major consequence of the pure automatism of the operations of the JCB was its inability to practise any deliberate influence on the quantity of money and adjust it to domestic economic needs. Credit policy of the commercial banks played an insignificant role in inducing changes in money supply because of their limited domestic activities. Changes in the money supply were largely induced by net changes in balance of payments flows and not by domestic expansionary policies. This situation involved relatively high money creation costs, since such surpluses actually represented part of the country's available resources.(1)

Moreover, the continuation of a dependent monetary system left the banking system without significant structural change as compared with the previous colonial period. The JCB was precluded from pursuing an independent monetary policy or practising any banking functions. The Board was therefore incapable of influencing the banking system and adjusting it to the particular environment of the Jordanian economy. The previous colonial biases continued to prevail. In particular, commercial banks continued to follow the traditional practice of holding a large proportion of their funds in overseas investment. Throughout the period 1951-1964, an average of 42.6% of total domestic deposits were re-deposited abroad. Secondly, a continued adherence to maintaining a high liquidity in commercial banking. The liquidity ratio, measured as a percentage of liquid assets to total deposits, averaged around 58% during the period of the JCB. This

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(1) For more details about the high economic costs of the money supply in Jordan during this period, See J. Salah, op.cit. PP. 52-57

was almost twice the 28% liquidity ratio customarily retained by the United Kingdom.(1) Thirdly, bank credit was still mainly extended to the financing of short-term transactions in the foreign trade sector. Although the sectoral distribution of bank credit is not available during this period, it was estimated that this sector absorbed about half of total bank credit.(2) This percentage seems to be excessive, especially if an account is made to the relative importance of this sector in the economy, which comprised one fifth of the GNP during this period.(3) Fourthly, a slow spread of banking services into the deeper and rural areas of the country. Although the network of bank branches expanded noticeably, reaching 43 offices at the end of the period, as compared with 12, 13 and 29 offices in the years 1950, 1955 and 1960,(4) the increase was mainly confined to the principal towns. According to the available data, nine of the thirteen bank branches in 1955 were situated in three main cities.(5)

(5) LACK OF EFFECTIVE DOMESTIC CENTRAL DIRECTION OF THE FINANCIAL SYSTEM MANIFESTED ITSELF IN A SLOW REALISATION OF THE NEED TO INNOVATE AND ESTABLISH A NEW FINANCIAL INFRASTRUCTURE TO PROMOTE INTERNAL DOMESTIC DEVELOPMENT.

Due to the continued strait-jacket constraint of effective foreign monetary control, not only was the JCB incapable of correcting the previous colonial biases in commercial banking, but it was also unable to strengthen the country's financial infrastructure. Under the JCB's regime, there was an obvious need to develop an effective network of specialised

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(1) J. Revell, The British Financial System (London: The Macmillan Press, Ltd. 1973). P.204.

(2) Abdul Malik, op.cit. P. 332.

(3) F.A.O. Mediterranean Development Project, Jordan Country Report, (Rome; 1967) Table 8, P.14.

(4) Central Bank of Jordan, Banking Control Department, (Unpublished data).

(5) The I.B.R.D. The Economic Development of Jordan, (Baltimore: The John Hopkins Press, 1957) P. 372.

credit institutions with adequate resources, to assist and finance the requirements of the basic economic sectors that were not adequately served by commercial banks (namely agriculture and manufacturing sectors). Although the government tried to promote and encourage agricultural development, either directly by providing grants and loans or indirectly by establishing and supporting agricultural credit institutions, its endeavours were still limited. Total loans granted by the government did not exceed JD 1 million at the end of 1955, while the credit outstanding of the Agricultural Bank, the only agricultural credit institution at that time, did not exceed JD 0.5 million.(1) It was only after the first decade of the period of the JCB that the Central Co-operative Union and the Agricultural Credit Corporation were established to specialise in agricultural credit. The former was established in 1959 to provide seasonal loans, supervision and advice to local agricultural societies, while the latter was established in 1960 to provide medium and long-term loans to farmers and to the central co-operative societies for agricultural needs. However, the JCB did not take any action or participate in any efforts to encourage and promote the activities of such institutions. As far as the manufacturing sector was concerned, the Board also did not contribute to any development of this sector. Throughout the period of the JCB, there was no effective industrial credit institutions with adequate resources to promote industrial development. The only specialised institution for financing manufacturing and tourism was the Industrial Development Fund, which was established in 1958. Due to its limited resources, the Fund was liquidated after the close of the JCB period (i.e. in July 1965), when the new and more efficient Industrial Development Bank was established to take the responsibility of financing such activities. The poor performance of the previous Industrial Fund can be shown by the fact that during the seven years of its existence, its credit extention amounted to only JD. 0.70 Million.(2)

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(1) The IBRD, The Economic Development of Jordan, op.cit. P. 51.

(2) Ibid.

Moreover, due to the very limited powers and responsibilities given to the JCB by the Currency Law, the Board was also unable to undertake any action with regard to the promotion of domestic money and capital markets. The creation of such markets could have been instrumental for internal development in the sense of providing alternative domestic avenues for bank overseas investment, and mobilising and channelling national savings towards internal development outlets.

The above discussion made it clear that the banking system during the JCB period was not an adequate instrument for the autonomous needs of a newly independent economy that desired economic growth. On the contrary, its operations must have inhibited development as a large part of the country's financial resources were invested abroad. This was worsened by the continued adoption of the dependent Currency Board System which further encouraged a continuous immobilisation of a considerable proportion of domestic resources in the form of currency cover invested in London. This situation would have been much better if the country had adopted an independent monetary system, or at least modified the existing JCB to enable it to exert some influence on banking activities. Although the immediate creation of a fully-fledged Central Bank was not justified when the country obtained political independence (mainly because of the rudimentary state of the Jordanian economy, the high financial dependence on the U.K. and the lack of a trained domestic staff with adequate experience to operate a central bank), it is difficult to accept the delay of establishing this institution which came after 14 years of political independence.(1)

Moreover, there was a failure on the part of the Jordanian Government to

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(1) For more details of the reasons of the delay of establishing the Central Bank. see J. Salah, op.cit PP. 35-36

carry out the recommendations of the IBRD Mission of 1955 regarding the Currency Board Law. According to the Mission's view, the Currency Board Law needed to be modified to enable the JCB to pursue some central banking functions, until such time as the creation of a fully-fledged central bank would be practical.(1) The Mission did recommend that legislation should require the Board to hold a certain proportion of its currency cover in domestic assets, thus enabling it to undertake a limited fiduciary issue, and also to rediscount certain domestic bank assets. However, one major result of the non-amendments of the Currency Board Law and the delay of establishing a central bank was that the economy had to suffer the aforementioned serious deficiencies in banking operations for a longer time after independence. This inertia further inhibited the emergence of development planning which was clearly essential for the newly independent economy.

(6) UNLESS AND UNTIL DEVELOPMENT PLANNING OCCURS, NO MEANINGFUL STRUCTURING OF THE BANKING SYSTEM CAN BE ACHIEVED BECAUSE OBJECTIVES HAVE NOT BEEN CLARIFIED.

The continued acceptance of the previous colonial financial situation, in which domestic monetary and banking policies were externally determined, was clearly against the internal autonomous needs of newly independent countries. Once political freedom was obtained, most of these countries embarked upon economic development programmes to develop their economies as autonomous and not subservient ones, with great emphasis being placed on promoting investment in domestic agricultural and manufacturing sectors. Such programmes required internal reallocation of financial resources to achieve the development profile envisaged. This situation demanded the replacement of the existing strait-jacket of Currency Board control of monetary institutions with independent control capable of

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(1) The IBRD, the Economic Development of Jordan, op.cit. P.35

assisting the developmental process, vested in central banks.

It is no coincidence therefore that the Central Bank of Jordan(CBJ) began its operations in 1964, and was at once followed by attempts at central planning of economic development under the Seven Year Programme for Economic Development, 1964-1970. Its creation was necessitated in view of the consequent required changes in the prevailing financial infrastructure to achieve the set development objectives. Such a development programme necessarily needed independent monetary and credit policies which the preceding Currency Board was unable to provide. Since its existence, the crucial task of the CBJ has been to correct the structural colonial biases in the banking system and adjust it to the particular context of the Jordanian economy and its domestic requirements. The CBJ has so far achieved partial success in four particular respects-

(i) <u>The Repatriation of Overseas Funds and the Liquidity of Commercial Banks</u>:

One major achievement has been the repatriation of funds transferred abroad through the operations of the commercial banks. Investment in overseas assets was restricted by the CBJ, and bank holdings of foreign assets were confined to levels required to meet overseas liabilities only. As a result, the composition of bank liquid assets has been significantly changed in favour of domestic assets, as compared with the previous period of the JCB when commercial banks were left free to choose their investment portfolios. While the average ratio of overseas investment to total bank liquid assets accounted for 90.7% during the years 1951-1964, it dropped noticeably to an average of 19.5% during the period 1965-1975. This was accompanied by a notable rise in the ratio of domestic assets to total liquidity which increased from only 9.3% to 80.5% during the two periods respectively. Despite this success, and attempts to lower the liquidity of the commercial banks, the impact of CBJ's policies has been limited. Commercial banks continued to maintain a high level of liquidity

averaged around 43.2% throughout the period 1965-1975. Although this was much lower than the previous figure of 58% during the JCB era, it was still considerably above the officially desired level.(1) The CBJ's failure in this respect is mainly due to the narrow scope of monetary policy in Jordan, which deprives the CBJ of the effective use of the monetary weapons available in its armoury.

(ii) <u>The Domestic Allocation of Credit and the Geographical Distribution of Banking Activities</u>:

By repatriating overseas funds, commercial banks were compelled to seek investment in domestic avenues. This was clearly reflected in the rise in domestic credit to deposit ratio which averaged around 75.3%, as compared with 57.4% under the previous JCB regime. Although the CBJ's policy of repatriating overseas funds has thereby strengthened the domestic credit base of the commercial banks, it has not satisfactorily succeeded in influencing the distribution of bank credit, neither on the sectoral side by diverting more resources to be in line with the development priorities nor on the regional side by expanding the scope of domestic credit to the interior and rural areas. Bank credit was still heavily geared to the financing of the foreign trade sector which absorbed on average 42% of total bank credit, whereas an average of only 2.5% and 11.1% went in favour of domestic agricultural and manufacturing sectors during the period 1965-1975. On the regional side, although the network of bank branches increased noticeably from 43 in 1964 to 77 in 1975, the increase was mainly confined to the Capital and to other main cities, leaving rural areas without adequate banking services. In 1975, for example, out of the 77 branches in the East Bank of Jordan, 42 were situated in Amman

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(1) The level of bank liquidity has always been considered high from the CBJ's point of view (See the CBJ's annual Reports of 1966 P.14, 1971 P.17, and 1975 P.34 )

(i.e. 55% of the total). Furthermore, not only did this concentration deprive other areas of banking facilities, but also even existing branches in these areas were unable to extend sufficient credit in their localities. Bank branches there were in fact merely deposit-receiving centres since they did not undertake much lending. These branches used to transfer the largest part of their deposits to head offices in Amman, not only because investment opportunities were more plentiful in the Capital, but also due to another institutional deficiency: that is, branch managers were not given adequate powers in regard to credit extension.(1) As a result, bank credit tended to be concentrated in Amman which absorbed, as one of the CBJ's studies reveals, about 95% of total credit facilities.(2)

(iii) Domestic Financial Infrastructure:

The contribution made by the CBJ to setting-up an adequate financial infrastructure has not been very significant. Despite some diversification of the financial system with the creation of some new specialised credit institutions during the last decade, credit facilities extended by the CBJ to these institutions only began in 1971, and constituted a small proportion of their total activities, comprising on average 8.8% during the period 1971-1975. On the other hand, the CBJ's contribution to the formation of adequate financial markets, either for the short-term funds or for the long-term investment, has been only nominal.(3)

(iv) The Economic Cost of Money Supply Creation:

Some partial success has been achieved by the CBJ with regard to reducing the high economic cost of money supply creation, particularly as compared with the procedures of the JCB, judged by the increasing role

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(1) Abed Alhadi Alawin, The Role of the Commercial Banks in the Economic Development of Jordan, M. A. Thesis (Beirut: The American University of Beirut, 1972) P.94.

(2) The Central Bank of Jordan, "Proposals about the role of the Commercial Banks in the 3 Year Development Plan, 1973", P.4. (Unpublished paper, in Arabic)

(3) It was not until 1978 that a domestic Stock Exchange Commenced operations in the Country.

played by net domestic factors in inducing changes in the money supply. These factors became responsible, on average, for 38.5% of the total changes in the money supply, as compared with only 8% during the previous JCB era. The increase in the relative importance of domestic factors meant that the money supply in Jordan became more adjusted to domestic needs and less connected to external fluctuations resulted from balance of payments transactions. Despite this improvement, however, external factors continued to be the dominant determinant of the money supply in Jordan. While such a situation can be partly related to the limited efficiency of the CBJ's instruments to adjust the money supply in accordance with domestic factors, it can be largely explained by the heavy dependence of Jordan on foreign aid. The latter made it easy for the CBJ to strictly follow the traditional policy of currency issue of maintaining a full foreign assets cover of domestic currency outstanding. This has been maintained, despite the ability of the CBJ to undertake fiduciary issues by including a certain percentage of the currency cover in the form of domestic assets.(1) Pursuing an 'appropriate' fiduciary issue policy would release part of the high foreign assets cover for financing internal development. The CBJ's policy of keeping a high ratio of foreign assets to local currency issued indicates a very cautious and conservative central banking approach, which is a relic of the previous currency Board System. This has been made evident by the fact that the above ratio was much higher than that which the preceding JCB used to keep, although the latter was precluded by its law from undertaking any fiduciary issue or engaging in domestic banking operations - the ratio averaged around 103%

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(1) The maximum ceiling of the fiduciary issue was fixed, in accordance with the 1971 Law, at 10% of total CBJ's liabilities. See: The CBJ, The Central Bank of Jordan During Ten Years (CBJ's publications, 1974)P.42

and 121% during the two periods respectively. This clearly reveals that the CBJ itself still conforms to one major operational characteristic of the colonial monetary system.

Summary and Conclusions.

The foregoing discussion has clearly shown that the financial readjustment problem still persists in Jordan. Despite some important improvements since 1964 under a new post-colonial central bank regime, the financial system still adheres, in many basic respects, to strictly conservative practices that were inherited from the pre-independence period, and which are now inappropriate for the achievement of the economy's development needs and objectives. However, before the structure and operations of the financial system are examined in the above content, the pattern of financial intermediation and economic growth actually realised needs to be established.

# CHAPTER 3

## FINANCIAL INTERMEDIATION AND ECONOMIC DEVELOPMENT IN JORDAN, 1955 - 1977

Chapter One has examined the historical evidence and theoretical explanations of the link between financial and real development. However, whether the two variables are closely connected depends, in reality, largely on the development strategy adopted and the extent to which the development of financial institutions has been relied upon as an instrument for promoting development. This Chapter will examine the significance officially given to domestic financial institutions in Jordan, and the extent to which financial intermediation has proceeded with economic development in the Jordanian context. For this purpose, the country's development strategies are outlined in Section 1, together with the significance attached to financial institutions; then, in Section II, the development of domestic financial intermediation is analysed; finally, the relationship between financial and real development is examined in Section III.

### I

### Jordanian Development Strategy and the Role Assigned to Financial Intermediaries.

As with almost all developing countries during their colonialist period, Jordan experienced a complete absence of any deliberate efforts to induce domestic development prior to independence. This was consistent with the economic and political dependence of the colonial territories on the U.K., and the consequent required diversion of interest towards promoting external ties with the metropolitan centre, rather than encouraging internal developmental activities. This situation of undefined national development objectives continued to prevail for 15 years after achieving independence. The first attempt to plan domestic development took place in 1962 with the preparation of the Five Year Programme for Economic

Development, 1962 - 1967. The reason for this delay can be explained by the very uncertain political circumstances which accompanied the early years of independence and an absence of efficient domestic machinery to plan and implement development programmes. However, due to financial difficulties resulting from a large reduction in the level of budget support received mainly from the U.S.A., this Programme became non-operative and was replaced by the Seven Year Programme For Economic Development, 1964 - 1970. The objectives and performance of this Plan were frustrated by the serious economic and social problems that followed the 1967 Arab-Israeli War together with the consequent occupation of the West Bank of Jordan. It was not until 1973 that a reasonable degree of political stability enabled the country to embark upon a new era of planned development with the launching of the Three Year Development Plan, 1973 - 1975. This was subsequently followed by the Five Year Plan, 1976 - 1980. The resumption of economic planning since 1973 has considerably influenced the growth of the economy and helped in revitalizing various economic activities that were largely disrupted during the earlier period of political unrest. This impact is clearly reflected in the following brief analysis of growth in the Jordanian economy during the period 1955 - 1977.

During the period under review, the Jordanian economy experienced high rates of growth, with an annual average rate of increse in GNP of 12.3%. This expansion in production was much faster than that of population, so that per capita GNP increased from JD 34.65 in 1955 to JD 213.90 by 1977, an average rate of increase of 8.7% per annum. Measured by constant prices, however, real growth rates were noticeably less, particularly in the 1970's during the periods of price inflation. Table 3.1 illustrates that over the whole period, real GNP rose by 6.9% whereas real per capita GNP increased by 3.7%.

However, the course of development that the Jordanian economy experienced during the 23 years covered by this analysis took three distinct phases, which clearly reflect three different rates of growth.

For economic and political reasons, the period as a whole can be therefore subdivided into:

(1) The period 1955 - 1966 during which the economy achieved noticeable progress within an environment of price stability. The above mentioned table demonstrates that the economy experienced high growth in GNP of 13.2% per annum. Development in this period occurred within a climate of price stability, with the annual rise in prices not exceeding 2%. Real GNP grew rapidly, rising from JD 49.90 million in 1955 to JD 158.63 million by 1966, an average annual rate of growth of 11.7%.(1) This substantially improved the standard of living amongst Jordanians whose real per capita GNP was more than doubled, rising from only JD 34.65 in 1955 to JD 80.52 in 1966.

(2) The period 1967 - 1972 which was generally characterised by a decline in economic activity, as a result of the Arab-Israeli War of 1967 and the internal disturbances of 1970. The upward trend of economic growth that prevailed in the previous period was greatly disrupted by the Arab-Israeli War of 1967 which caused great damage to the economy and hindered its notable progress. The adverse effects of this War were evident in 1968 when real GNP declined by 5.2%. Although the economy in 1969 began to recover gradually from the War and its aftermath (during which GNP rose by 9.9%), it was again faced by new retardations resulting from the internal disturbances which culminated in a civil war in September 1970. These upheavals had largely reversed the upward trend of development

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(1) This high rate of growth in GNP can be favourably compared with that of other countries during the same period. A study conducted by the U.N. in 1967 classified Jordan as the second amongst 63 developing countries that achieved the highest rates of growth during 1955 - 1965. See: The United Nations, "The Problems and Policies of Economic Development, An Appraisal of Recent Experience", World Economic Survey, Part One, 1967 (N.Y. 1968) Table 6, P.20.

Table 3.1

## GNP, Population Growth, Price Level, and Trend in Per Capita Income, 1955 - 1977

| Year | GNP** Millions of JD Current Prices (1) | Population (millions of Persons) (2) | Per Capita GNP JD Current Prices (3) | Nominal Annual Rate of Change % | | | Cost of Living Index* (1955=100) (4) | Rate of Inflation (5) | Real GNP (1955 Prices) (6=1 ÷ 4) | Real Per-Capita GNP (1955 Prices) (7=3 ÷ 4) | Real Annual Rate of Growth | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | GNP | Population | Per Capita GNP | | | | | GNP | Per-Capita GNP |
| 1955 | 49.90 | 1.44 | 34.65 | - | - | - | 100.0 | - | 49.90 | 34.65 | - | - |
| 1956 | 68.30 | 1.48 | 46.15 | 36.9 | 2.7 | 33.1 | 101.0 | 1.0 | 67.62 | 45.69 | 35.5 | 31.7 |
| 1957 | 70.40 | 1.53 | 46.01 | 3.1 | 3.4 | -3.7 | 102.0 | 1.0 | 69.02 | 45.11 | 2.4 | -2.1 |
| 1958 | 77.10 | 1.58 | 48.80 | 9.5 | 3.3 | 5.9 | 103.0 | 1.0 | 74.85 | 47.38 | 8.2 | 4.9 |
| 1959 | 99.10 | 1.64 | 60.43 | 28.5 | 3.8 | 23.8 | 104.0 | 1.0 | 95.29 | 58.11 | 27.2 | 22.6 |
| 1960 | 105.70 | 1.69 | 62.54 | 6.6 | 3.0 | 3.5 | 105.0 | 1.0 | 100.66 | 59.56 | 5.7 | 2.4 |
| 1961 | 127.10 | 1.71 | 74.33 | 20.2 | 1.2 | 18.9 | 107.0 | 1.9 | 118.78 | 69.47 | 17.9 | 16.6 |
| 1962 | 130.80 | 1.74 | 75.17 | 2.9 | 1.7 | 1.2 | 109.0 | 1.9 | 120.00 | 68.96 | 1.0 | -0.6 |
| 1963 | 137.60 | 1.79 | 76.87 | 5.2 | 2.9 | 2.1 | 111.0 | 1.8 | 123.96 | 69.25 | 4.4 | - |
| 1964 | 160.60 | 1.85 | 86.81 | 16.7 | 3.3 | 13.0 | 113.0 | 1.8 | 142.12 | 76.82 | 14.5 | 11.0 |
| 1965 | 180.40 | 1.91 | 94.45 | 12.3 | 3.2 | 8.9 | 115.0 | 1.8 | 156.87 | 82.13 | 10.4 | 7.0 |
| 1966 | 185.60 | 1.97 | 94.21 | 2.8 | 3.1 | - | 117.0 | 1.7 | 158.63 | 80.52 | 1.0 | -3.1 |
| 1967 | 206.00 | 2.08 | 99.04 | 10.9 | 3.5 | 5.3 | 119.0 | 1.7 | 173.10 | 83.23 | 9.4 | 3.8 |
| 1968 | 197.30 | 2.15 | 91.77 | -4.2 | 3.4 | -7.1 | 120.0 | 0.8 | 164.41 | 76.48 | -5.2 | -8.4 |
| 1969 | 231.50 | 2.23 | 103.81 | 17.3 | 3.7 | 11.9 | 129.3 | 7.8 | 179.04 | 80.28 | 9.1 | 5.2 |
| 1970 | 226.20 | 2.31 | 97.92 | -2.1 | 3.6 | -5.8 | 137.2 | 6.1 | 164.87 | 71.37 | -8.3 | -11.2 |
| 1971 | 199.30 | 2.38 | 83.74 | -11.9 | 3.0 | -14.4 | 145.0 | 5.7 | 137.44 | 57.75 | -16.5 | -19.7 |
| 1972 | 221.10 | 2.46 | 89.88 | 11.0 | 3.3 | 7.2 | 156.1 | 7.7 | 141.73 | 57 .58 | 2.9 | - |
| 1973 | 241.20 | 2.54 | 94.96 | 9.0 | 3.2 | 5.6 | 173.4 | 11.1 | 139.10 | 54.76 | -1.4 | -4.9 |
| 1974 | 307.20 | 2.62 | 117.25 | 27.4 | 3.1 | 23.2 | 207.0 | 19.4 | 148.41 | 56.64 | 6.4 | 3.7 |
| 1975 | 368.00 | 2.70 | 136.30 | 19.9 | 3.1 | 16.2 | 231.6 | 11.9 | 158.89 | 58.85 | 6.7 | 3.6 |
| 1976 | 544.20 | 2.78 | 195.75 | 47.8 | 3.0 | 43.3 | 267.0 | 15.3 | 203.82 | 73.31 | 28.5 | 25.8 |
| 1977 | 613.90*** | 2.87 | 213.90 | 12.4 | 3.2 | 9.2 | 305.7 | 14.5 | 200.82 | 70.00 | -1.5 | -4.2 |
| Av. 55-66 | | | | 13.2 | 2.8 | 9.7 | | 1.3 | | | 11.7 | 8.2 |
| Av. 67-72 | | | | 3.5 | 3.4 | -0.5 | | 4.9 | | | -1.4 | -5.1 |
| Av. 73-77 | | | | 23.3 | 3.1 | 19.5 | | 14.4 | | | 7.7 | 4.8 |
| Av. 55-77 | | | | 12.3 | 3.0 | 8.7 | | 5.2 | | | 6.9 | 3.7 |

For Source and Notes: See following Page

Table 3.1

Source: (1) GNP Figures for 1955 - 1958: FAO Mediterranean Development Project, Jordan Country Report, (Rome: 1967) Table 8. P. 14

(2) GNP and Population Figures For the rest of the period: IMF, IFS, (1972 Supplement); and IMF, IFS (Nov. 1978).

* An official cost of living index is only available since 1967. Therefore, it is found necessary to construct our own index considering 1955 as a base year. In so doing, the following points were taken into account:

(1) According to the Three Year Development Plan(P.2), the period prior to 1966 experienced price stability with a maximum rise in the price level of 2% annually. Therefore, it is assumed that prices increased on average by 1% a year between 1955 and 1960, and by 2% per annum between 1961 - 1966.

(2) The official cost of living was constructed in 1967 for Amman and Zerka only, while the rest of the Kingdom was included in 1969. Therefore, our index for the period 1967 and 1968 considered the average rise in the cost of living in Amman and Zerka; and afterwards the official index for all the Kingdom was taken into consideration.

** GNP Figures from 1969 onwards are for the East Bank of Jordan only.

*** Preliminary.

of 1969, with most economic sectors showing diminishing performances as reflected in the overall decline in real GNP of 8.3%. This situation deteriorated with the rise in the price level (averaging 4.9% per annum) which further depressed real achievements within the economy. From 1967 to 1972, both GNP and per capita GNP declined in real terms by respective ratios of 1.4% and 5.1%, as against considerable real growth rates of 11.7% and 8.2% achieved during the previous period.

(3) The period 1973 - 1977 which witnessed a resumption of economic activity and an overall expansion in total output accompanied the launching of a new era of economic and social development programmes. The adoption of new plans in 1973 and 1976 promoted growth in all sectors of the economy, with the GNP accelerating rapidly at an average rate of 23.3% per annum. Unfortunately, this high nominal rate of growth overstates the real rate because of the high level of inflation. Between 1973 and 1977, prices rose at an average annual rate of 14.4%. This had the effect of suppressing the annual real growth of GNP to 7.7% and real per capita GNP to 4.8% per annum.

The Five Year Plan (1976 - 1980) was a continuation of the planned development efforts initiated by the Three Year Plan (1973 - 75). Both plans aimed at achieving similar long-term objectives and also adopted analogous strategies to achieve the selected goals.[1] The main objectives of both plans can be summarised as follows:[2]

(1) Realisation of high growth rates in GNP in real terms with a view of raising per capita income levels.[3]

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(1) The discussion of the development plans excludes the previously mentioned Seven Year Plan (1964-1970), which was not implemented because of the 1967 war and its aftermath. However, the long-term goals adopted by this Plan were similar to those discussed above.

(2) National Planning Council, Three Year Plan for Economic Development (1973-1975), P.15; and the Five Year Plan for Economic Development (1976-1980) P.26.

(3) GNP was planned to grow at averages of 8% and 12% in both plans respectively.

(2) Achievement of structural changes in the Jordanian economy in favour of the commodity-producing sectors and increasing their relative share in GDP at the expense of the service sector.(1)

(3) Achievement of the highest possible level of employment, development of manpower capabilities and increase of productivity.

(4) A reduction in the trade deficit, expansion and diversification of exports, and strengthening of the balance of payments components related to factor income from abroad.

(5) Enhancement of the general budget's dependence on domestic financial resources for the purpose of eliminating dependence on foreign aid in the long-run.

(6) Distribution of economic activities, public services and ensuing gains on a more equitable basis among the different regions of the country.

To achieve these goals, development planners in Jordan defined certain development strategies which were basically similar in both plans. Among these strategies,(2) four are of special relevance here, and have direct implications for the role of financial intermediation. The discussion of these strategies is necessary for two main reasons: firstly, to analyse the main structure and characteristics of the Jordanian economy. Secondly, to assess later the contribution of the financial system in facilitating and implementing these strategies.

(a) <u>Narrowing the gap between aggregate consumption and GNP and redistributing resources in favour of investment</u>.

A characteristic feature of the Jordanian economy was the high level of private and public consumption which, in most years, exceeded gross

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(1) This was explicitly mentioned as a general objective of the Five Year Plan, whereas the Three Year Plan implicitly aimed at restructuring the economy by allocating more resources in directly-producing sectors.

(2) The adopted development strategies include many institutional and policy measures covering the economic, social, and educational aspects of development, See: <u>Three Year Plan</u>, PP.16-19; <u>Five Year Plan</u>, PP. 27-31.

national income. As shown by Figure 3.1, aggregate consumption exceeded GNP in 10 out of the 14 years between 1959 - 1972.(1) During this period, aggregate consumption averaged around 103% of GNP. The private sector constituted the major source of consumption, claiming an average of three quarters of the total during the whole period.(2) While the high level of domestic consumption could be partly explained by the so-called "demonstration effect" (which is familiar in developing countries), it has been recently accentuated by the rising inflationary pressures that accompanied the economy. Inflation usually intensifies consumption because, in an environment of continuous price increases, people seek to buy more goods before further anticipated rises in their prices take place. At the same time, individuals are usually unwilling to save when the value of their savings is being continuously undermined by rising prices. Such effects were exacerbated in the Jordanian case as people received negative real returns on their financial holdings during the inflationary years, due to the deliberate adoption of a low interest rate policy (to be discussed later). As far as the demonstration effect in Jordan was concerned, this was particularly encouraged by the liberal commercial policy which left the door wide open to satisfy the increasing demand for imported consumer goods. Such a policy was made possible because of the considerable inflow of foreign aid which played a fundamental role in maintaining equilibrium in the Jordanian economy as will be demonstrated in detail.

Thus, one major concern of development planners was to reduce the consumption/GNP gap and direct more resources away from consumption and towards capital formation, so as to raise the rate of growth in income.

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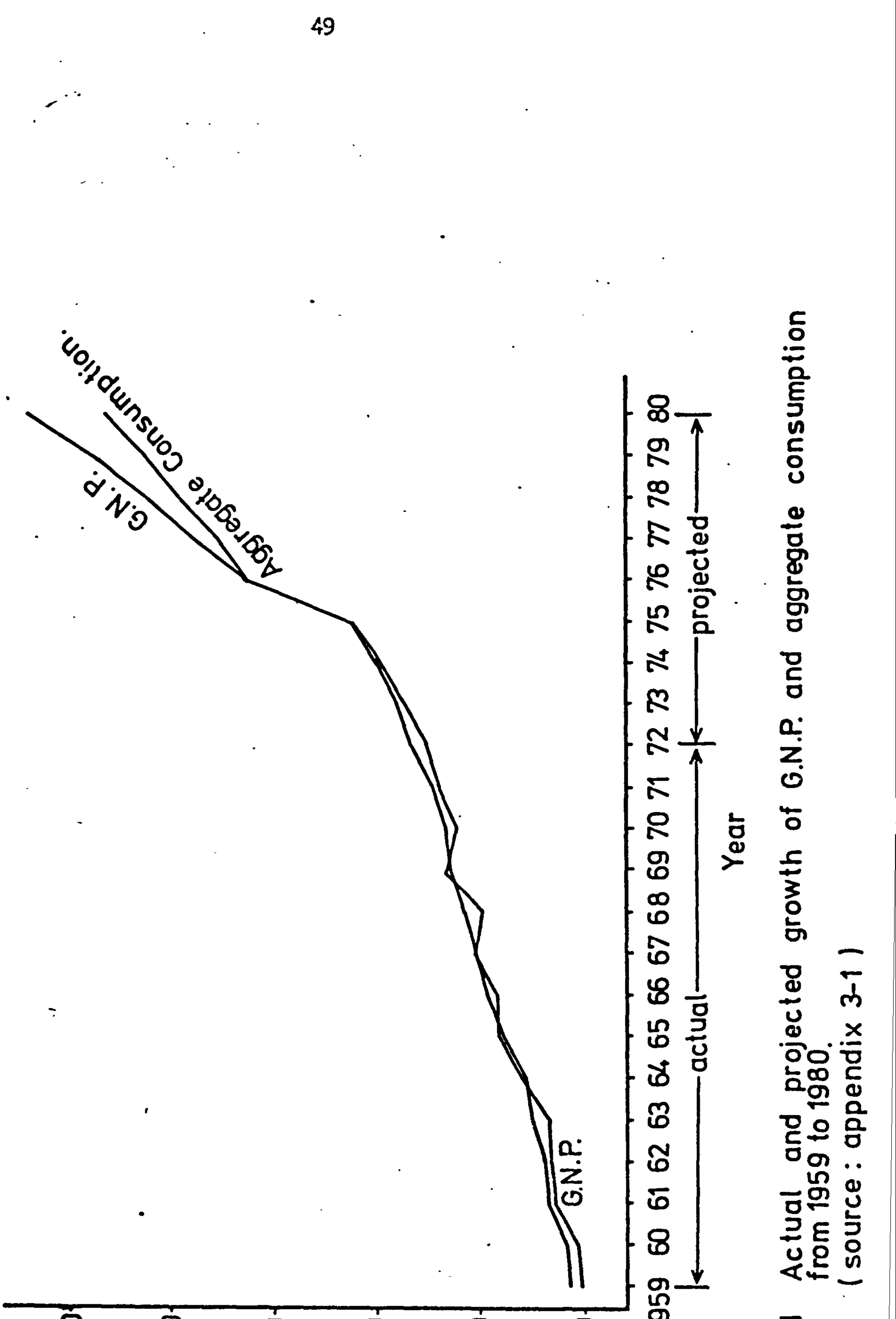
(1) Detailed National Accounts Statistics are only available since 1959.

(2) See Appendix 3.1.




Actual and projected growth of G.N.P. and aggregate consumption from 1959 to 1980.
( source : appendix 3-1 )

Fig. 3-1

Such a deliberate shift of emphasis on investment took time to achieve. Resource re-allocation was slight during the Three Year Plan, and only became noticeable under the 5 yr plan. Table 3.2 illustrates this fact. The average ratio of consumption to GNP was planned to reach 101% during the first Plan as compared with a corresponding average of 94% during the second Plan. These planned rates are compared with actual consumption/GNP ratios of 104% during 1955 - 1966, and 102% between 1967 and 1972. At the same time, the shift towards investment was noticeable under the second Plan which projected capital formation to comprise an average of 30% of GNP per annum, as compared with an annual planned ratio of 20% in the first Plan. Clearly, the aim here was to redistribute resources in favour of investment, so raising the proportion of national income going to capital formation, which accounted for an average of 15% during the period 1959 - 1972.

Table 3.2 Actual and Projected Allocation of Resources Between Consumption and Investment, 1959 - 1980

% of GNP

| | Actual | | Planned | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | (1) Three Year Plan | | | | (2) Five Year Plan | | | | | |
| | Average 1959-66 | Average 1967-72 | 1973 | 1974 | 1975 | Average 1973-75 | 1976 | 1977 | 1978 | 1979 | 1980 | Average 1976-80 |
| Aggregate Consumption | 104 | 102 | 101 | 101 | 100 | 101 | 100 | 96 | 94 | 91 | 88 | 94 |
| Gross Capital Formation | 15 | 16 | 21 | 20 | 19 | 20 | 35 | 38 | 32 | 25 | 20 | 30 |
| Expenditure on consumption & investment | 119 | 118 | 122 | 121 | 119 | 121 | 135 | 134 | 126 | 116 | 108 | 124 |

(b) <u>The encouragement of and further reliance on the private sector as a major source of financing development expenditures</u>.

Jordan has a mixed economy wherein both the private and the public sectors are participants in the development process, but with some two thirds of total capital formation being undertaken and financed by the former sector during the period 1959 - 1972 (Table 3.3). One basic assumption made in both plans was that the private sector should continue to respond to development efforts and assume an important role in attaining the set development objectives. Public investments were placed in areas and projects which could encourage and help to create profitable investment opportunities, which the private sector, it was hoped, would be attracted to. The table shows that public investment was heavy during the first two years of the Three Year Plan, forming 60% and 57% of total capital expenditures. This could be explained by the government intention to revitalize economic activity and encourage private investment after the recession of the 1970.(1) The private sector was expected to gradually increase its contribution to development expenditures to 50% of the total by the third year of the Plan. On the other hand, the Five Year Plan further stressed the role of the private sector which was planned to provide half of the JD 765 million allocated for investment during the Plan's period. The private sector in both plans was expected to continue to play an active and ever-increasing role in domestic activities, thus representing the largest source of development finance in the long-term period.

(C) <u>Increasing the reliance on domestic, rather than foreign, sources for financing economic development</u>.

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(1) National Planning Council, <u>Three Year Plan</u>, op.cit. P.34

Table 3.3

## Actual and Projected Distribution of Development Funds Between the Private and Public Sectors, 1959 - 1980

JD million

| | Actual | | | | | | | | Planned | | | | | | | | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 59.- 66 | | | | 67 - 72 | | | | Three Year Plan | | | | | | | | | | Five Year Plan | | | | | | | | | | | |
| | Total | | Average Annual | | Total | | Average Annual | | 73 | | 74 | | 75 | | Total | | Average Annual | | 76 | | 77 | | 78 | | 79 | | 80 | | Total | | Average Annual | |
| | V. | % | V. | % | V. | % | V. | % | V. | % | V. | % | V. | % | V. | % | V. | % | V. | % | V. | % | V. | % | V. | % | V. | % | V. | % | V. | % |
| (1) Public Investment | 65 | 37 | 8 | 37 | 79 | 32 | 14 | 32 | 35 | 60 | 35 | 57 | 30 | 50 | 100 | 56 | 34 | 56 | 76 | 51 | 86 | 48 | 80 | 48 | 77 | 54 | 63 | 50 | 382 | 50 | 76 | 50 |
| (2) Private Investment | 109 | 63 | 14 | 63 | 170 | 68 | 28 | 68 | 23 | 40 | 26 | 43 | 30 | 50 | 79 | 44 | 26 | 44 | 74 | 49 | 95 | 52 | 86 | 52 | 66 | 46 | 62 | 50 | 383 | 50 | 77 | 50 |
| (3) Total Capital Expenditure | 174 | 100 | 22 | 100 | 249 | 100 | 42 | 100 | 58 | 100 | 61 | 100 | 60 | 100 | 179 | 100 | 60 | 100 | 150 | 100 | 181 | 100 | 166 | 100 | 143 | 100 | 125 | 100 | 765 | 100 | 153 | 100 |

Source: Appendix 3.2 & Appendix 3.3

Jordan is an open economy whose economic activities depend largely on the inflow of foreign resources. Aggregate demand in Jordan has always exceeded total domestic resources and the gap has had to be filled by a considerable inflow of foreign aid and, to some extent, by net factor income from abroad.(1) Foreign finance has therefore been essential to maintain equilibrium in the Jordanian economy where, as shown earlier, aggregate expenditures on both consumption and investment comprised, on average, 118% of GNP during 1959 - 1972.(2) Foreign aid has been given in the form of budget support (mainly from Arab Oil-Producing Countries(3)) to help meeting current expenditures.(4) As Table 3.4 illustrates, there has been a noticeable imbalance between government current revenue and current expenditure, as domestic sources of revenues covered, on average, only 60% of total current expenditures. However, whenever foreign aid exceeded any deficit balance between current domestic revenues and expenditures, the resultant surplus on current account was allocated to finance public investment.(5) The

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(1) Jordan is characterised by a chronic trade deficit since exports lag substantially behind imports. The magnitude of this deficit is evident by observing the high ratio of net imports to GNP which averaged around 27% during 1959-1972. Net imports constitute resources made available to the economy in excess of what was produced within the economy itself. This was mainly financed by foreign aid and net factor income from abroad (largely remittances from Jordanians working overseas) which respectively comprised 15% and 6% of GNP during the same period. See Appendixes 3.1 & 3.2

(2) See Table 3.2

(3) Foreign aid received from Arab Oil-Producing Countries comprised, on average, about two thirds of the total inflow of aid during 1970-1977, whereas the U.S.A. contributed to the remaining percentage (see Central Bank of Jordan's monthly bulletins). However, the Arab aid emerged as the predominant element after the 1967 Arab-Israeli War and the consequent financial support received from Arab Governments as agreed upon in the Khartoum Arab Summit in that Year.

(4) According to the definition of the Jordanian Dept. of Statistics, foreign aid is considered part of current government receipts.

(5) This was the case in 12 out of the 14 years between 1959-1972. (See Appendix 3.2)

Table 3.4

## Actual and Projected Contribution of Domestic and Foreign Sources to Government Current Revenues, 1959 - 1980

(JD million)

| | Actual | | Planned | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | Three Year Plan | | | | Five Year Plan | | | | | |
| | Average 1959-66 | Average 1967-72 | 1973 | 1974 | 1975 | Average 1973-75 | 1976 | 1977 | 1978 | 1979 | 1980 | Average 76-80 |
| 1. Current Revenues | 36.8 | 76.3 | 88.5 | 94.8 | 101.2 | 94.8 | 168.0 | 187.0 | 205.0 | 222.0 | 251.0 | 206.6 |
| (a) Domestic Sources | 22.2 | 35.3 | 48.5 | 54.8 | 61.2 | 54.8 | 107.0 | 126.0 | 144.0 | 161.0 | 190.0 | 145.6 |
| (b) Foreign aid | 14.6 | 41.0 | 40.0 | 40.0 | 40.0 | 40.0 | 61.0 | 61.0 | 61.0 | 61.0 | 61.0 | 61.0 |
| 2. Current Expenditures | 32.3 | 68.8 | 85.0 | 91.2 | 97.9 | 91.4 | 147.0 | 160.0 | 172.0 | 183.0 | 195.0 | 171.4 |
| 3. Govt. Savings (1-2) | 4.5 | 7.5 | 3.5 | 3.6 | 3.3 | 3.4 | 21.0 | 27.0 | 33.0 | 39.0 | 56.0 | 35.2 |
| (a) as % of (1) | 60.3 | 46.3 | 54.8 | 57.8 | 60.4 | 57.8 | 63.7 | 67.3 | 70.2 | 72.5 | 75.6 | 70.5 |
| (b) as % of (1) | 39.7 | 53.7 | 45.2 | 42.2 | 39.6 | 42.2 | 36.3 | 32.7 | 29.8 | 27.5 | 24.4 | 29.5 |
| (b) as % of (3) | 324.4 | 546.6 | 1143.0 | 1111.0 | 1212.0 | 1176.6 | 290.4 | 226.0 | 184.8 | 156.4 | 108.9 | 173.3 |

Source : Appendix 3.2

significance of foreign aid can be gauged by the high ratio of aid received to gross government savings, which averaged around 436% during 1959 - 1972. Clearly, without foreign aid, government savings would certainly be negative, and the government would find it extremely difficult to allocate resources for development.

As indicated earlier, one major objective of development programmes was to encourage the general budget dependence on domestic financial sources for the purpose of eliminating dependence on foreign aid in the long-term period. For this purpose, the Three Year Plan required improvements in tax collection techniques, more appropriate rent assessment and the imposition of new taxes (such as the inheritance and capital gains taxes).(1) This would have the effect of increasing the relative importance of domestic sources from an average ratio of 53.3% of total current revenue during 1959-1972 to 57.8% during the Plan's period 1973 - 1975. The Five Year Plan required a further increase in the relative importance of domestic revenue, which was envisaged to comprise an average of 70.5% between 1976 - 1980. During this period, it is intended to reduce dependence on foreign aid to an average of 29.5% of total current revenue as compared with 42.2% under the previous plan (1973_1975). These figures were compared with an actual ratio of 46.7% which was experienced between 1959-1972 ( See Figure 3.2).

Moreover, development programmes reveal a noticeable reliance on other domestic sources of financing development.(2) As demonstrated by table 3.5, domestic public sector intermediation was envisaged to rise from an average of 55.3% of total public investment under the Three Year Plan to 60.3% under the Five Year Plan, as against an average of only 26.6% during the period 1959 - 1972. This is an aggregate of three

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(1) National Planning Council, Three Year Plan, op.cit. P.26

(2) However, despite the importance attached to domestic sources of financing public investment, foreign loans and economic and technical assistance from abroad were also significant in financing government capital formation. See Table 3.5

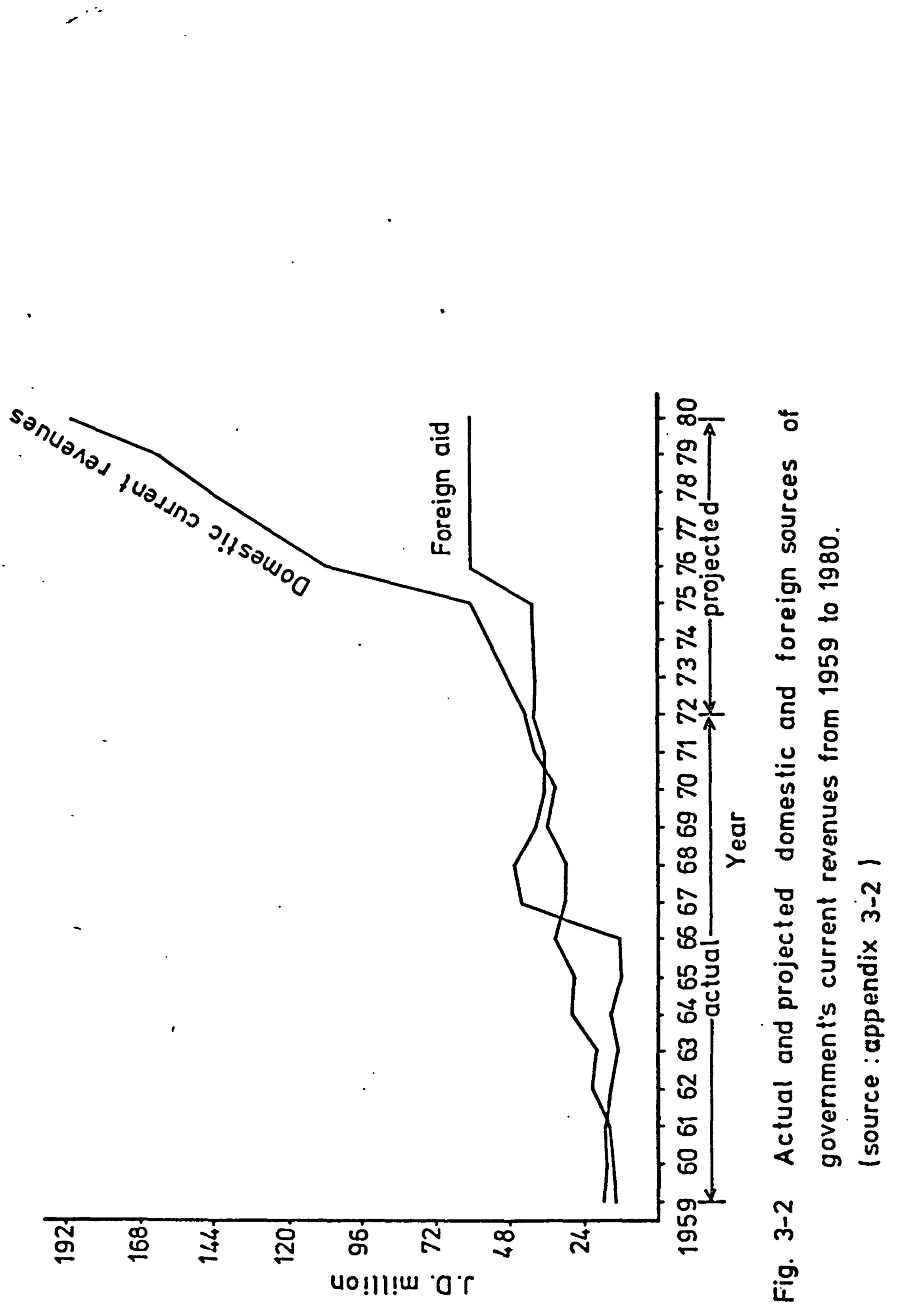


Fig. 3-2 Actual and projected domestic and foreign sources of government's current revenues from 1959 to 1980.
(source : appendix 3-2 )

domestic channels through which the government hopes to transfer resources for development purposes-

(1) Government bonds were planned to provide funds capable of financing 27.6% of public investment under the Three Year Plan and 20.1% under the Five Year Plan. These were compared with a corresponding figure of only 7.3% during 1967 - 1972.(1)

(2) Borrowing from the banking system, either directly or through issuing treasury bills, was projected to finance 20.4% of public investment during 1973 - 1975, whereas this was reduced to 9.2% during 1976 - 1980.

(3) Finally, intermediation by the public sector through transferring resources to the private sector for investment purposes was very important under the Five Year Plan, comprising 31 % of public capital expenditures. This was compared with a projected average of 7.3% under the Three Year Plan and an actual average of 9.9% during 1959 - 1972.

On the private sector's side, domestic savings were the main source for financing private investment throughout the period under review, as the same table shows. This source, however, experienced a relative decline under the Five Year Plan due to a noticeable rise in other sources of finance. During the period of the Plan, loans and grants from the government were envisaged to form, on average, 31% of private investment (compared to 7.8% under the earlier Three Year Plan and 6.1% during 1959 - 1966), whereas foreign sources were projected to finance 19.2% (compared to 9,5% and 3.4% during the two previous periods respectively). On the whole, however, total resources available for investment in the private sector were in excess of expenditures on real investment, thus directing the surpluses towards financial asset holdings.(2)

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(1) Domestic borrowing was non-existent during 1959 - 1966.

(2) Except for the period 1959 - 1966 where the private sector financed an average of 17.6% of total investment by drawing from its financial asset holdings.

Table 3.5

## Actual and Projected Sources of Financing Development Expenditures, 1959 - 1980.

(% of Gross Capital Formation)

| | Actual | | Planned | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | Three Year Plan | | | | Five Year Plan | | | | | |
| | Average 59-66 | Average 67-72 | 73 | 74 | 75 | Average 73 - 75 | 76 | 77 | 78 | 79 | 80 | Average 76 - 80 |
| I. Public Sector | | | | | | | | | | | | |
| 1. Current Surplus (Savings) | 69.6 | 46.9 | 9.9 | 10.4 | 11.1 | 10.4 | 27.6 | 31.4 | 41.3 | 50.6 | 88.9 | 43.0 |
| 2. Govt. Bonds | - | 7.3 | 28.4 | 28.6 | 25.8 | 27.6 | 15.8 | 14.0 | 18.7 | 73.4 | 28.6 | 20.1 |
| 3. Borrowing From the Banking Syste | - | 26.1 | 13.8 | 19.3 | 22.8 | 20.4 | 9.2 | 8.1 | 8.8 | 9.1 | 11.0 | 9.2 |
| 4. Capital Transfers from Abroad | 67.6 | 6.5 | 17.1 | 5.8 | 16.8 | 16.5 | 3.9 | 4.7 | 5.0 | 6.5 | 7.7 | 5.5 |
| 5. Foreign Loans | 19.9 | 33.9 | 48.5 | 51.8 | 60.4 | 53.6 | 94.8 | 94.1 | 75.0 | 54.6 | 19.4 | 67.6 |
| 6. Total Resources Available for Investment (1 to 5) | 157.1 | 120.3 | 122.7 | 125.9 | 136.9 | 128.5 | 151.3 | 152.3 | 148.8 | 144.2 | 155.6 | 150.4 |
| Minus | | | | | | | | | | | | |
| 7. Repayment of Loans & Obligations | - | 9.8 | 17.9 | 20.1 | 28.5 | 21.2 | 22.3 | 15.1 | 17.5 | 18.2 | 23.8 | 19.4 |
| 8. Loans & Grants to Private Sector | 10.3 | 9.5 | 4.8 | 5.8 | 8.4 | 7.3 | 29.0 | 37.2 | 31.3 | 26.0 | 31.8 | 31.0 |
| 9. Gross Capital Expenditures | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| 10. Changes in Monetary Balances 6 - (7 + 8 + 9) | 46.8 | 1.0 | - | - | - | - | - | - | - | - | - | - |
| Domestic Public Sector Intermediation ( 2 + 3 + 8 ) | 10.3 | 42.9 | 52.0 | 53.7 | 57.0 | 55.3 | 54.0 | 59.3 | 58.8 | 58.5 | 71.4 | 60.3 |
| II. Private Sector | | | | | | | | | | | | |
| 1. Current Surplus (Savings) | 73.5 | 133.6 | 151.1 | 138.6 | 117.2 | 135.6 | 58.1 | 57.9 | 68.6 | 109.1 | 124.2 | 83.6 |
| 2. Loans & Grants From Govt. | 5.4 | 6.8 | 7.4 | 7.8 | 8.1 | 7.8 | 29.8 | 33.7 | 29.1 | 30.3 | 32.3 | 31.0 |
| 3. Net Foreign Loans & Invst. | 3.5 | -0.1 | 6.1 | 10.2 | 12.2 | 9.5 | 24.3 | 18.9 | 15.1 | 18.2 | 19.3 | 19.2 |
| 4. Total Resources Available for Investment (1 to 4) | 82.4 | 140.3 | 164.6 | 156.6 | 137.5 | 152.9 | 112.2 | 110.5 | 112.8 | 157.6 | 175.8 | 133.8 |
| 5. Gross Capital Expenditures | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| 6. Net Changes in Monetary Balances (4 - 5) | -17.6 | 40.3 | 64.6 | 56.6 | 37.5 | 52.9 | 12.2 | 10.5 | 12.8 | 57.6 | 75.8 | 33.8 |

Source: Appendix 3.2 & Appendix 3.3

(d) <u>The diversification of the industrial structure of the economy and reducing its dependence on services</u>.

The Jordanian economy, unusually, was very largely service-oriented. The services sector constituted, on average, some 65% of GDP throughout the 1959-1972 period, and employed more than 60% of the total labour force.(1) Development Planners realised that these percentages were excessive, especially as compared with other countries at similar stages of development, where the comparative GDP figures are not more than 40% and the employment figures range between 15% and 25%.(2)

To correct this structural bias in the Jordanian economy, both development plans emphasised the necessity of diversifying and strengthening other domestic activities by concentrating on the commodity-producing sectors. To this end, the Three Year Plan required an annual average growth rate in these sectors of 9.9%, with a lower services sector annual average growth rate of 6.9%. This would have had the effect, as Table 3.6 reveals, of increasing the relative importance of the commodity-producing sectors from 36.2% in 1973 to 37.6% by the year 1975. Most of this increase was planned to come about in the manufacturing sector which was expected to grow in relative importance from 11.4% to 13.0% during the Plan's period. However, the Five Year Plan shifted further towards industrialisation by allocating 30% of total Plan's investment in the manufacturing sector, as compared with only 14% under the previous Plan. This would encourage the manufacturing sector to develop at an average rate of 26.2% per annum, thus increasing its relative GDP importance from 19.9% in 1976 to 28.3% by 1980. As a result, the commodity-producing sectors would increase their relative contribution to GDP from 38.9% to 44.1% during the Plan's period, thus reducing the relative share of the services sector from 61.1% to 55.9%.

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(1) National Planning Council, <u>Five Year Plan</u>, op.cit. P.22.

(2) Ibid.

Table 3.6 Actual and Projected Sectoral Distribution of GDP and Investment Allocation Among Sectors, 1959 - 1980

(%)

| | Actual | | | | Projected. | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1959 - 1966 | | 1967 - 1972 | | Three Year Plan (73 - 75) | | | | Five Year Plan (76 - 80) | | | |
| | Sectoral Share in GDP | Average Annual Growth | Sectoral Share in GDP | Average Annual Growth | Sectoral Share in GDP | | Average Annual Growth | Sectoral Share in investment | Sectoral Share in GDP | | Average Annual Growth | Sectoral Share in Ivst. |
| | | | | | 1973 | 1975 | 1973 - 1975 | 1973 - 1975 | 1976 | 1980 | 1976 - 1980 | 1976 - 1980 |
| 1. Agriculture | 20.1 | 12.0 | 18.2 | 7.6 | 17.5 | 17.1 | 6.4 | 15.5 | 9.5 | 8.3 | 7.0 | 17.9 |
| 2. Mining & Manufacturing | 8.9 | 10.0 | 10.9 | 8.0 | 11.4 | 13.0 | 14.0 | 14.6 | 19.9 | 28.3 | 26.2 | 30.0 |
| 3. Construction | 5.1 | 10.5 | 4.7 | 2.3 | 1.5 | 1.7 | 11.2 | 19.5 | 7.7 | 5.3 | 4.1 | 11.2 |
| 4. Electricity & Water Supply | 0.9 | 17.5 | 1.2 | 7.0 | 5.8 | 5.8 | 16.6 | 5.5 | 1.8 | 2.2 | 17.1 | 5.6 |
| Total Material Producing Sectors | 35.0 | 11.1 | 35.0 | 6.8 | 36.2 | 37.6 | 9.9 | 55.1 | 38.9 | 44.1 | 21.1 | 64.7 |
| 5. Transport | 10.7 | 4 | 8.3 | 3.8 | 7.5 | 6.8 | 2.9 | 23.8 | 8.3 | 8.5 | 10.6 | 15.6 |
| 6. Whole-Sale & Retail Trade | 21.2 | 5 | 19.5 | 9.0 | 18.8 | 18.5 | 7.6 | n.a. | 17.8 | 15.3 | 7.2 | n.a. |
| 7. Banking | 1.2 | 17.5 | 1.9 | 1.8 | 2.1 | 2.0 | 6.8 | n.a. | 2.1 | 2.2 | 17.1 | n.a. |
| 8. Housing | 7.6 | 7.8 | 6.9 | 5.2 | 6.8 | 6.8 | 7.9 | n.a. | 5.6 | 5.9 | 12.0 | n.a. |
| 9. Public Administration & Defence | 15.6 | 5.5 | 18.4 | 10.3 | 18.2 | 18.3 | 8.1 | n.a. | 17.5 | 15.2 | 7.0 | n.a. |
| 10. Other Services | 8.7 | 7.7 | 10.0 | 10.1 | 10.4 | 10.0 | 5.6 | n.a. | 9.8 | 8.8 | 8.5 | n.a. |
| Total Service Producing Sectors | 65.0 | 6.3 | 65.0 | 7.8 | 63.8 | 62.4 | 6.9 | 44.9 | 61.1 | 55.9 | 8.6 | 35.3 |
| GDP | 100.0 | 7.4 | 100.0 | 7.2 | 100.0 | 100.0 | 8.0 | 100.0 | 100.0 | 100.0 | 11.9 | 100.0 |

Source: (1) Department of Statistics, National Accounts, 1967 - 1972

(2) National Planning Council, Three Year Development Plan, 1973 - 1975

(3) _____, Five Year Development Plan, 1976 - 1980

Most of the decrease in the later sector would occur in the wholesale and retail trade sector, which was expected to decline in relative importance from 17.8% to 15.3% during the Plan's period, as can be seen by Figure 3.3. These planned figures clearly revealed the shift in economic policy towards industrialisation which was adopted as one main strategy to achieve the selected development goals.

Having discussed the main Jordanian development strategies, their implications for domestic financial intermediation must be discussed together with the role assigned to financial institutions in the achievement of the development goals set for the economy.

The above development strategies have clear implications for the role of financial institutions. Firstly, a proper allocation of resources available for these institutions would greatly help in narrowing the gap between aggregate consumption and GNP, thus channelling further resources to finance investment. The Five Year Plan asked the commercial banks to reduce consumer credits, requiring the Central Bank to apply strict measures for this purpose.(1) Secondly, the large size of, and the significance attached to, the private sector in economic activity enable domestic financial intermediaries to participate effectively in carrying out and facilitating the saving-investment process. According to the Five Year Plan, the financial system was expected to extend sufficient credit to finance the large private investment envisaged by the Plan.(2) Thirdly, increasing reliance on domestic sources for financing development implies an increased need for financial intermediation to promote growth. In addition to institutionalising the private sector's savings, which were shown to constitute the major source for financing private investment, the financial system was also relied upon to finance part of public investment.

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(1) National Planning Council, Five Year Plan, op.cit. P.72

(2) Ibid, P.69

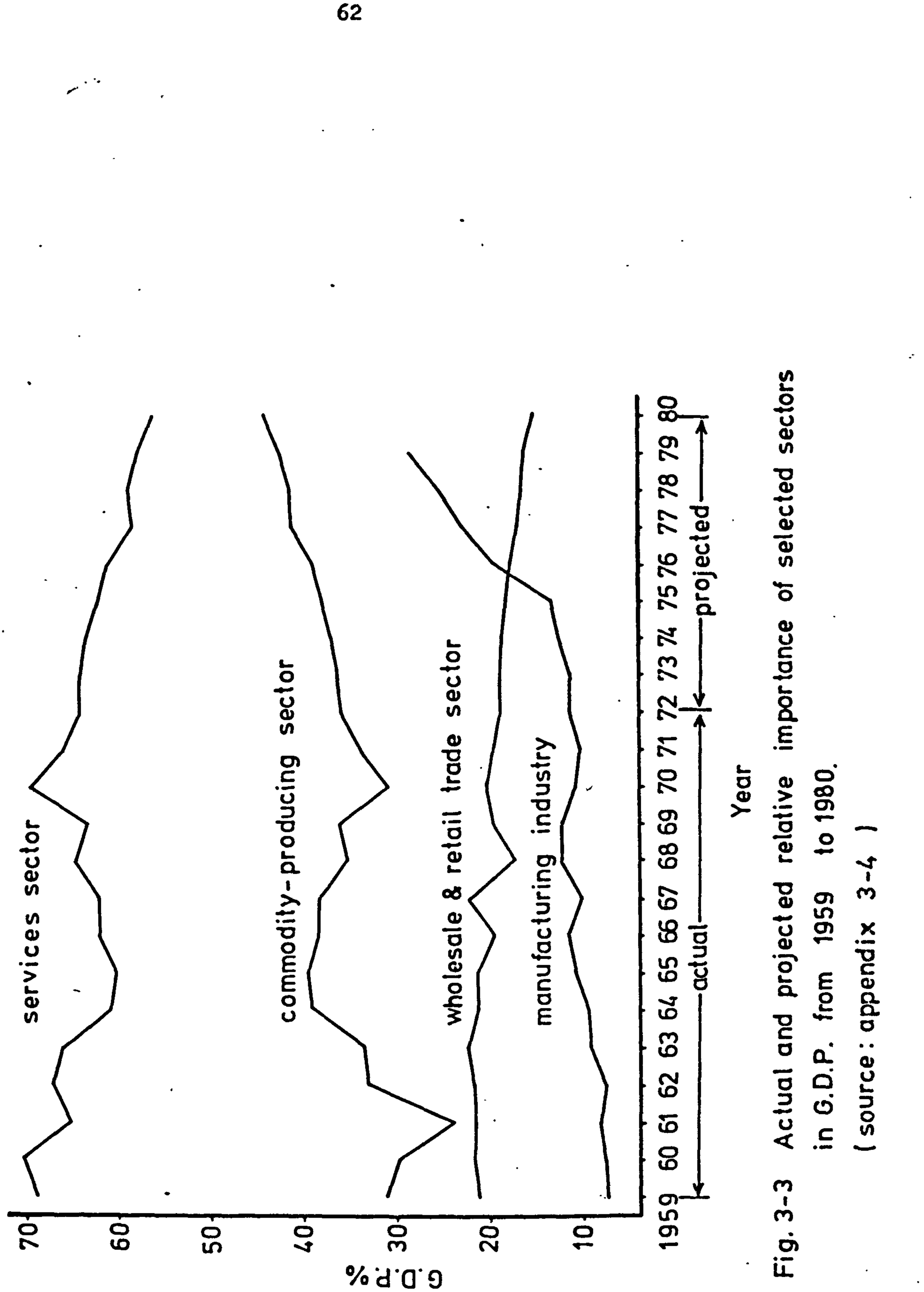


Fig. 3-3 Actual and projected relative importance of selected sectors in G.D.P. from 1959 to 1980.

( source : appendix 3-4 )

It was shown that domestic borrowing, either direct from the banking system or through issuing treasury bills and government bonds, gained an increasing importance during the period under study. Finally, as the central concern of economic policy shifted towards restructuring the economy by concentrating on industrialisation, the financial system was expected to facilitate this strategy by allocating resources in a way conducive to the required structural changes. Both Plans required commercial banks to adjust the sectoral distribution of their credit in accordance with the new direction of policy trend, and the Central Bank in particular was required to ensure such a change.(1) Subsequently, the Five Year Plan further emphasised the role that should be played by specialised credit institutions to induce the above structural shift in the economy.(2)

Although both the Three Year Plan and the Five Year Plan stressed the significance of financial institutions in the development process,(3) the former was, however, less specific in defining the ways and methods by which these institutions can help in attaining the selected objectives. Their role was generally prescribed under the Three Year Plan, with emphasis being placed on financing the development expenditures of the government. The Plan also recommended the establishment of some specialised institutions that were deemed necessary for economic development;(4) the adoption of certain policies that encourage the flow of financial resources towards development (in particular, the Central Bank was required to exercise qualitative credit control over bank credit and stop paying interest on bank deposits maintained with the Central Bank).

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(1) Three Year Plan, P.46 and Five Year Plan, P.72

(2) Five Year Plan, P.72

(3) Three Year Plan, PP. 44-46; Five Year Plan, PP. 65-72

(4) As will be shown in detail in Part C, the Plan asked for the creation of a government pension fund, a housing bank, and also required the Central Bank to study the possibility of setting up a domestic stock exchange.

was
The latter measure/intended to increase government revenues and also to induce banks to seek alternative outlets for their funds.

The Five Year Plan was much more specific in defining the developmental role of the financial system. It first outlined the major operational deficiencies that were seen discouraging to development. Then, secondly, a set of goals were defined to be implemented by the financial system during the Plan's period. To achieve these goals, the Plan, finally, recommended the adoption of certain measures relating to the activities of different types of financial institutions. Such measures and policies, and their effect on development, will be revealed in the following chapters when the role of each type of institution is discussed in detail.

## II

## Development of Domestic Financial Intermediation Between 1955-1977

As was shown in Chapter 1, the M2/GNP ratio can be used as an appropriate method for measuring financial intermediation and the degree of financial development attained by developing countries.(1) It was argued there that although this measure reveals only the intermediation of the banking system and does not, therefore, reflect the whole intermediation by different financial institutions, its adoption seems suitable for developing countries where the banking sector accounts for the bulk of the financial assets.

As is the predominant case in developing countries, the non-bank financial sector in Jordan was still of little significance in the overall financial structure. Table 3.7 reveals the structure of the Jordanian financial system and the relative importance of each type of intermediary as measured by asset holdings. The total assets held by the specialised sector as of December 31, 1977 comprised only 16.4% of the total assets held by the entire financial system. This sector constituted nine intermediaries specialising in different areas and activities, which

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(1) See Chapter 1, PP. 13 - 14

distinguished them from the ordinary commercial banks;(1) of these six operated as specialised credit agencies for financing and promoting certain sectors of the economy. Their relative weight in the entire financial system accounted for 13%. Predominant among these institutions was the Housing Bank which claimed alone 6.8% of the total assets held by the financial system, i.e. about equal to the share of the other five credit institutions taking together. The remaining non-bank financial intermediaries performed three different specialised activities carried out by the Post Office Savings Fund and contractual savings institutions (insurance companies and the Pension Fund). The operations of these institutions were still of minor importance, with their relative share in total asset holdings constituting only 3.4%. Moreover, not only were the non-bank financial intermediaries of small importance in the country's financial structure, but many of these institutions were of recent inception, such as the Housing Bank, the Post Office Savings Fund, and the Pension Fund. However, the setting-up of these institutions added to the significance of the non-bank financial sector as shown by the table.

The table also demonstrates the predominance of the banking sector in the country's financial structure, its relative asset share comprising some 83.6% of total asset holdings. Commercial banks represented 45.4%, whereas the remaining percentage of 38.2% comprised the relative asset share of the Central Bank of Jordan. Commercial banks were the first financial instituions to operate in the country - their existence dated back to 1925, when the Ottoman Bank started business in Jordan.(2) The Central Bank of Jordan, on the other hand, was created in 1964 to supersede the previously operating Jordan Currency Board.

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(1) Differences between ordinary banks and specialised financial institutions will be discussed in Part C of this thesis. See PP. 207 - 210

(2) For further details of the early evolution of the commercial banks in Jordan, see Chapter 2, P. 25

Table 3.7 Relative Importance of Different Types of Financial Institutions in Jordan as of December 31, 1977

| Type of Institution | Year of Establishment | Assets (JD million) | % of the Total Assets of the Financial System |
|---|---|---|---|
| A. Banking System (1 plus 2) | | 676.74 | 83.6 |
| 1. Commercial Banks | From 1925 | 367.39 | 45.4 |
| 2. Central Bank of Jordan | 1964 | 309.35 | 38.2 |
| B. Specialised Credit Institutions (3 through 8) | | 105.49 | 13.0 |
| 3. Municipal & Village Loans Fund | 1957 | 10.57 | 1.3 |
| 4. Agricultural Credit Corp. | 1960 | 11.34 | 1.4 |
| 5. Industrial Development Bank | 1965 | 12.13 | 1.5 |
| 6. Housing Corporation | 1965 | 11.63 | 1.4 |
| 7. Jordan Co-op. Organisation | 1968 | 4.74 | 0.6 |
| 8. Housing Bank | 1974 | 55.08 | 6.8 |
| C. Other Non-Bank Financial Institutions (9 through 11) | | 27.62 | 3.4 |
| 9. Post Office Savings Fund | 1974 | 1.29 | 0.2 |
| 10. Insurance Companies | From 1951* | 10.74** | 1.3 |
| 11. Pension Fund | 1976 | 15.59 | 1.9 |
| D. Total Non-Bank Financial Sector (B plus C) | | 133.11 | 16.4 |
| E. Total Financial System (A plus D) | | 809.85 | 100.0 |

Source: (1) Central Bank of Jordan, Monthly Statistical Bulletin (March, 79)
(2) The above non-bank Financial Institutions, Annual Reports.

* As is shown in Chapter 9, Jordan lacks adequate published statistics and information pertaining to the insurance sector. The above year was related to the establishment of the first Jordanian company for which statistics were obtainable; although branches of foreign companies definitely operated in the country before this year.

** Due to the absence of a combined balance sheet covering the insurance sector, the above figure of the assets held by insurance companies of JD 10.74 million is an estimated one and should be, therefore, taken with reservation. It was based on an estimation that the largest three insurance companies, for which statistics were obtained, comprised 80% of the insurance industry in Jordan. (See Chapter 9, footnote 1 P. 296)

Given the above predominance of the banking system in the country's financial structure, the adoption of the M2/GNP ratio seems to be appropriate for measuring domestic financial intermediation and the degree of financial development attained by Jordan. The financial intermediation ratio (or the financial development ratio) as measured by the size of money and quasi money to GNP can be used as a broad index of the extent to which the Jordanian financial system penetrates in the real economy. The small relative weight of the non-bank financial sector means that this sector represents only a relatively small part of the entire flow of saving to investment that takes place through the financial system. Moreover, the M2 figures which are included in the above ratio cover not only the money and quasi money held by the commercial banks and the Central Bank, but also that of the largest specialised credit institution represented by the Housing Bank. Since the latter institution is, unlike other specialised institutions, active in deposit mobilisation as will be shown in Chapter 8, its deposits are taken into consideration when calculating the size of the Jordanian M2. This situation further adds to the validity of using the M2/GNP as an appropriate broad measure for financial intermediation in Jordan, since the relative importance of the financial institutions whose operations are reflected in this ratio is increased from 83.6% to 90.4% of the entire financial system.(1) Despite this, however, one should take the above ratio as a crude measure because it does not cover the whole intermediation by the financial system.(2)

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(1) i.e. by adding the relative share of the Housing Bank to that of the banking system. See Table 3.7

(2) Although Goldsmith's financial interrelations ratio (total financial assets ÷ national wealth) is more representative of the intermediation carried out by the entire financial system, its adoption is difficult in Jordan because of the lack of the required statistics, especially those related to the insurance companies. (For more details of the alternative measures for financial development, see Chapter 1. PP.10-14).

Taking M2/GNP as an indicator, Jordan experienced a notable and steady progress in domestic financial intermediation throughout the period 1955 - 1977. During this period, the ratio rose from 45.8% to 71.5%, thus reflecting an increasing degree of penetration of the financial system into the real economy. Table 3.8 reveals that the financial intermediation ratio grew steadily during the three distinct phases of economic development, rising from an average of only 34.7% during 1955 -1966 to 57.2% and 71.3% during 1967 - 1972 and 1973 - 1977 respectively. The relatively small ratio of M2/GNP during the first period reflected a lower financial path that the economy experienced during early years of independence. Prior to 1964, the financial system was comparatively underdeveloped under the Currency Board system which had little impact on diversifying financial institutions and encouraging their contribution to development. With the establishment of the Central Bank in 1964 and the consequent diversification and promotion of domestic financial institutions, the latter's involvement in various economic activities increased noticeably, as reflected in the steady rise in the financial intermediation ratio during the last two periods.

The movement in the above ratio throughout the whole period is consistent with the theoretical explanation stated earlier of the general increasing importance that the financial development takes as the economy undergoes development.(1) The steady rise in M2/GNP meant that, as generally experienced in other countries during the course of economic development, Jordanian financial assets grew more rapidly than the growth in real output.(2) This can be explained by the monetization

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(1) See Chapter 1, P.11

(2) This implied that income velocity of money (which is the inverse of money income ratio) declined gradually during the same period. Table 3.8 reveals this fact, showing that the velocity of money (related to the narrow and broad definition of the money supply) exhibited a declining trend throughout the whole period. This is consistent with the general behaviour of this ratio in a developing economy, which can be largely related to the monetization argument as discussed above.

Table 3.8 Structure of Money Supply and Development in Money/Income Ratio, 1955 - 1977

(JD million)

| | Composition of Money Supply | | | | | | | | | | GNP | Money/Income Ratios | | Income Velocity Ratios | | Changes over the Preceding Period | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Currency in Circulation (1) | | Demand Deposits (2) | | M1 (1 + 2) (3) | | Quasi Money (4) | | Total M2 (3 + 4) (5) | | | M1/GNP | M2/GNP | GNP/M1 (V1) | GNP/M2 (V2) | GNP | M1 | M2 |
| | Value | % of (5) | Value | % of (5) | Value | % of (5) | Value | % of (5) | Value | % | | | | | | | | |
| 1955 | 11.13 | 54.1 | 6.36 | 30.9 | 17.49 | 85.0 | 3.08 | 15.0 | 20.57 | 100.0 | 44.90 | 38.9 | 45.8 | 2.5 | 2.2 | - | - | - |
| 1956 | 14.56 | 63.4 | 5.68 | 24.8 | 20.24 | 88.2 | 2.71 | 11.8 | 22.95 | 100.0 | 68.30 | 29.6 | 33.6 | 3.3 | 3.0 | 52.1 | 15.7 | 11.1 |
| 1957 | 14.71 | 57.2 | 7.49 | 29.2 | 22.20 | 86.4 | 3.50 | 13.6 | 25.70 | 100.0 | 70.40 | 31.5 | 36.5 | 3.1 | 2.7 | 3.0 | 9.6 | 11.9 |
| 1958 | 15.16 | 54.2 | 9.17 | 32.8 | 24.33 | 87.0 | 3.64 | 13.0 | 27.97 | 100.0 | 77.11 | 31.6 | 36.3 | 3.1 | 2.7 | 9.5 | 9.5 | 8.8 |
| 1959 | 15.27 | 52.8 | 8.97 | 31.0 | 24.24 | 83.8 | 4.70 | 16.2 | 28.94 | 100.0 | 99.10 | 24.5 | 29.2 | 4.0 | 3.4 | 28.5 | -1.0 | 3.4 |
| 1960 | 15.63 | 50.5 | 10.46 | 33.8 | 26.09 | 84.3 | 4.87 | 15.7 | 30.96 | 100.0 | 105.70 | 24.7 | 29.3 | 4.0 | 3.4 | 6.1 | 7.6 | 7.0 |
| 1961 | 16.97 | 47.6 | 11.95 | 33.6 | 28.92 | 81.2 | 6.68 | 18.8 | 35.60 | 100.0 | 127.10 | 22.7 | 28.0 | 4.3 | 3.6 | 17.6 | 10.8 | 15.0 |
| 1962 | 19.04 | 44.2 | 14.43 | 33.6 | 33.47 | 77.8 | 9.57 | 22.2 | 43.04 | 100.0 | 130.80 | 25.6 | 32.9 | 3.9 | 3.0 | 2.3 | 15.7 | 20.9 |
| 1963 | 20.40 | 42.5 | 16.45 | 34.2 | 36.85 | 76.7 | 11.18 | 23.3 | 48.03 | 100.0 | 137.60 | 26.8 | 34.9 | 3.7 | 2.8 | 4.6 | 10.1 | 11.5 |
| 1964 | 23.12 | 43.1 | 16.73 | 31.2 | 39.85 | 74.3 | 13.81 | 25.7 | 53.66 | 100.0 | 160.60 | 24.8 | 33.4 | 4.0 | 2.9 | 16.7 | 8.1 | 11.7 |
| 1965 | 26.50 | 41.2 | 20.77 | 32.3 | 47.27 | 73.5 | 16.99 | 26.5 | 64.26 | 100.0 | 180.40 | 26.2 | 35.6 | 3.8 | 2.8 | 11.8 | 18.6 | 19.7 |
| 1966 | 30.33 | 40.0 | 25.70 | 33.9 | 56.03 | 73.9 | 19.79 | 26.1 | 75.82 | 100.0 | 185.60 | 30.1 | 40.8 | 3.3 | 2.4 | 2.8 | 18.5 | 17.9 |
| 1967 | 51.52 | 54.8 | 23.72 | 25.2 | 75.24 | 80.0 | 18.84 | 20.0 | 94.08 | 100.0 | 206.00 | 36.5 | 45.7 | 2.7 | 2.2 | 10.7 | 34.3 | 24.1 |
| 1968 | 63.55 | 58.4 | 24.43 | 22.4 | 87.98 | 80.8 | 20.84 | 19.2 | 108.82 | 100.0 | 197.30 | 44.6 | 55.2 | 2.2 | 1.8 | -5.0 | 16.9 | 15.7 |
| 1969 | 71.29 | 60.0 | 24.93 | 21.0 | 96.22 | 81.0 | 22.61 | 19.0 | 118.83 | 100.0 | 231.50 | 41.5 | 51.3 | 2.4 | 1.9 | 17.3 | 9.4 | 9.2 |
| 1970 | 82.43 | 63.8 | 23.04 | 17.8 | 105.47 | 81.6 | 23.67 | 18.4 | 129.14 | 100.0 | 226.20 | 46.6 | 57.1 | 2.1 | 1.8 | -3.0 | 9.6 | 8.7 |
| 1971 | 83.01 | 61.4 | 24.99 | 18.5 | 108.00 | 79.9 | 27.11 | 20.1 | 135.11 | 100.0 | 199.30 | 54.2 | 67.8 | 1.8 | 1.5 | -12.0 | 2.3 | 4.6 |
| 1972 | 81.47 | 55.7 | 33.55 | 22.9 | 115.02 | 78.6 | 31.45 | 21.4 | 146.47 | 100.0 | 221.10 | 52.0 | 66.2 | 1.9 | 1.5 | 11.0 | 6.5 | 8.4 |
| 1973 | 97.48 | 55.4 | 41.77 | 23.7 | 139.25 | 79.1 | 36.82 | 20.9 | 176.07 | 100.0 | 241.20 | 57.7 | 72.9 | 1.7 | 1.4 | 9.1 | 21.1 | 20.2 |
| 1974 | 115.49 | 53.3 | 54.73 | 25.3 | 170.22 | 78.6 | 46.52 | 21.4 | 216.74 | 100.0 | 307.20 | 55.4 | 70.5 | 1.8 | 1.4 | 27.4 | 22.2 | 23.1 |
| 1975 | 139.03 | 50.1 | 79.47 | 28.6 | 218.50 | 78.7 | 59.24 | 21.3 | 277.74 | 100.0 | 368.00 | 59.3 | 75.5 | 1.7 | 1.3 | 19.8 | 28.4 | 28.1 |
| 1976 | 161.49 | 45.0 | 102.09 | 28.4 | 263.58 | 73.4 | 95.34 | 26.6 | 358.92 | 100.0 | 544.20 | 48.4 | 65.9 | 2.1 | 1.5 | 47.8 | 20.6 | 29.2 |
| 1977 | 188.25 | 42.9 | 126.55 | 28.8 | 314.80 | 71.7 | 124.20 | 28.3 | 439.00 | 100.0 | 613.90 | 51.3 | 71.5 | 2.0 | 1.4 | 12.8 | 19.4 | 22.3 |
| Average 55 - 66 | 49.2 | | 31.8 | | 81.0 | | 19.0 | | 100.0 | | | 28.0 | 34.7 | 3.6 | 2.9 | 14.1 | 11.2 | 12.6 |
| 67 - 72 | 59.0 | | 21.3 | | 80.3 | | 19.7 | | 100.0 | | | 45.9 | 57.2 | 2.2 | 1.8 | 3.2 | 13.2 | 11.8 |
| 73 - 77 | 49.3 | | 27.0 | | 76.3 | | 23.7 | | 100.0 | | | 54.4 | 71.3 | 1.8 | 1.4 | 23.4 | 22.3 | 25.0 |
| 55 - 77 | 51.8 | | 28.0 | | 79.8 | | 20.2 | | 100.0 | | | 38.5 | 48.5 | 2.8 | 2.2 | 13.2 | 14.3 | 15.0 |

Source; IMF, IFS (1973 Supplement) and (December 1978)

argument and the income effect which both lead to higher growth rates in monetary and financial assets as compared with the increase in real production. On the one hand, the rapid monetization of the subsistence sectors of the economy and the replacement of financial liabilities for commodity money led to higher financial growth as compared with the increase in GNP. On the other hand, the rise in the real per capita income during the course of economic development worked to increase the demand for financial assets in relation to real output.

The steady rise in the M2/GNP ratio during the course of Jordan's economic development would suggest that growth in the real sector was accompanied, and facilitated, by a parallel development in the financial sector. The relationship between financial and real development and the extent to which both were connected will be revealed in the next section of this chapter. What is necessary here is to examine the degree of financial development attained by Jordan, and how this can be compared with the experience of other countries.

Judged by the M2/GNP ratio, Jordan has attained a high level of financial development which was favourably compared with developing as well as developed countries. Table 3.9 reveals financial data pertaining to 25 countries classified in order according to the degree of financial development attained by each country. Among these countries, Jordan came seventh in achieving a high level of financial development, with the ratio of M2/GNP reaching 71.5% by 1977. Switzerland attained the highest financial development ratio (116.4%), whereas Chile experienced the lowest ratio of only 14.0%. The high level of the Jordanian M2/GNP ratio meant a high degree of financial development attained by Jordan, which was much higher than what was experienced in most of the developing countries, and even as compared with many developed countries included

Table 3.9 Monetary/Income Ratios and Composition of Total Liquidity in Selected Countries (1977)

%

| Country | Monetary/Income Ratios | | | | | | Total Liquidity (M2) | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | M2/GNP | | (M2-CC)/GNP | | Quasi Money/GNP | | CC | DD | M1 | Q | M2 |
| | | Rank | | Rank | | Rank | | | | | |
| Switzerland | 116.4 | 1 | 102.3 | 1 | 75.6 | 1 | 11.8 | 23.2 | 35.0 | 65.0 | 100.0 |
| Austria | 101.9 | 2 | 90.0 | 2 | 75.4 | 2 | 11.7 | 14.3 | 26.0 | 74.0 | 100.0 |
| Portugal | 94.5 | 3 | 76.5 | 4 | 46.5 | 7 | 19.0 | 31.8 | 50.8 | 49.2 | 100.0 |
| Japan | 85.4 | 4 | 77.8 | 3 | 52.4 | 5 | 8.8 | 29.8 | 38.6 | 61.4 | 100.0 |
| Spain | 84.8 | 5 | 76.0 | 5 | 52.6 | 4 | 10.4 | 27.5 | 37.9 | 62.1 | 100.0 |
| Cyprus | 78.3 | 6 | 68.1 | 6 | 57.4 | 3 | 13.0 | 13.6 | 26.6 | 73.4 | 100.0 |
| Jordan | 71.5 | 7 | 40.8 | 16 | 20.1 | 19 | 42.9 | 28.9 | 71.8 | 28.2 | 100.0 |
| Germany | 65.0 | 8 | 59.2 | 7 | 48.5 | 6 | 8.7 | 16.7 | 25.4 | 74.4 | 100.0 |
| Greece | 63.4 | 9 | 49.8 | 9 | 44.5 | 8 | 21.3 | 8.5 | 29.8 | 70.2 | 100.0 |
| Singapore | 62.5 | 10 | 48.3 | 11 | 34.4 | 12 | 22.8 | 22.1 | 44.9 | 55.1 | 100.0 |
| Egypt | 59.6 | 11 | 34.3 | 18 | 18.0 | 20 | 40.9 | 28.0 | 68.9 | 31.1 | 100.0 |
| Norway | 58.6 | 12 | 50.3 | 8 | 39.3 | 9 | 14.3 | 18.7 | 33.0 | 67.0 | 100.0 |
| Netherlands | 56.1 | 13 | 49.6 | 10 | 34.5 | 11 | 11.5 | 27.2 | 38.7 | 61.3 | 100.0 |
| France | 53.4 | 14 | 46.8 | 12 | 25.6 | 16 | 12.2 | 39.7 | 51.9 | 48.1 | 100.0 |
| Malaysia | 48.4 | 15 | 38.7 | 17 | 29.0 | 14 | 20.0 | 20.0 | 40.0 | 60.0 | 100.0 |
| U.S.A. | 46.3 | 16 | 41.6 | 13 | 28.1 | 15 | 10.3 | 28.9 | 39.2 | 60.8 | 100.0 |
| Canada | 45.2 | 17 | 41.4 | 15 | 31.9 | 13 | 8.4 | 21.1 | 29.5 | 70.5 | 100.0 |
| Finland | 44.1 | 18 | 41.5 | 14 | 35.6 | 10 | 5.8 | 13.5 | 19.3 | 80.7 | 100.0 |
| Tunisia | 41.3 | 19 | 31.3 | 19 | 14.1 | 21 | 24.3 | 41.4 | 65.7 | 34.3 | 100.0 |
| Sweden | 35.7 | 20 | 28.4 | 21 | 25.4 | 17 | 20.0 | 8.8 | 28.8 | 71.2 | 100.0 |
| Iran | 35.6 | 21 | 30.9 | 20 | 20.2 | 18 | 13.2 | 29.9 | 43.1 | 56.9 | 100.0 |
| Turkey | 30.8 | 22 | 23.1 | 22 | 4.9 | 24 | 25.0 | 59.1 | 84.1 | 15.9 | 100.0 |
| Philippines | 21.7 | 23 | 17.1 | 23 | 11.8 | 22 | 21.2 | 24.2 | 45.4 | 54.6 | 100.0 |
| Peru | 21.6 | 24 | 15.5 | 24 | 3.9 | 25 | 27.9 | 54.0 | 81.9 | 18.1 | 100.0 |
| Chile | 14.0 | 25 | 11.2 | 25 | 8.4 | 23 | 20.0 | 20.0 | 40.0 | 60.0 | 100.0 |

Source: IMF, IFS (November 1978)

in the sample.(1) Such a high level of domestic financial intermediation could be a reflection of a high propensity of Jordanians to hold a large proportion of their assets in financial forms. It could be also related to the very success of the financial system in institutionalising domestic savings.

However, the above interpretations should be made with some reservation.(2) A close examination of the structure of the Jordanian money supply seems to, somehow, change the above picture. Table 3.9 shows that a considerable proportion of Jordanian M2 (accounting for 42.9% by 1977) was in the form of currency in circulation which were kept idle outside the financial system. Among all the countries included in the sample, Jordan experienced the highest ratio of currency in circulation to money supply. Such immobilised funds were included within the financial assets in measuring the degree of financial intermediation and development attained by different countries. However, a high element of currency in the money supply structure is usually an indication of

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(1) The Jordanian financial intermediation ratio was also favourably compared with a sample of developing and developed countries included in a recent study of Ronald McKinnon in 1979. In eight of "semi-industrial" developing countries, the M2/GNP ratio was found to account for 25% during the period 1960 - 1975, whereas the same ratio in five selected industrial countries averaged around 60%. See: Ronald McKinnon, Financial Repression and the liberalisation Problem within less Developed Countries (First International Conference on the Financial Development of Latin America and the Caribbean: Feb. 26th to 28th, 1979) PP. 7-9

(2) One should accept with caution the ratio of M2/GNP as a measure for financial development in developed countries. While this method is generally suitable for developing countries where the banking sector occupies the dominant share in the financial sector, this is not the usual case in developed countries in which the M2 constitutes only part of a large range of financial assets which should be all considered in measuring financial intermediation and development.

underdevelopment of the financial system and its inability to institutionalise domestic savings. Thus, if the currency element were to be excluded from the M2/GNP measure, a more meaningful comparison of financial development can be obtained. Considering (M2-CC)/GNP as an indicator, Jordan showed a much lower degree of financial development as compared with the same group of countries included in the sample. This accounted for 40.8% compared to the previous M2/GNP ratio of 71.5%, thus dropping Jordan's rank along the financial development ladder from the 7th to the 16th. The comparative table made it clear that when the currency element was excluded, all developed countries surpassed Jordan in the degree of financial development attained. Despite this, however, the level of financial development, measured by the modified ratio, was still favourably compared with other developing countries.

The comparatively high relative weight of the currency element in Jordanian M2 needs explanation. In addition to the prevalence of an underdeveloped banking habit, especially in rural areas, the above situation can be partly related to domestic political instability which further accentuated the public's desire to hold their assets in readily available forms of savings represented in cash. During the first phase of development (1955 - 66), a comparative degree of political stability helped to encourage the development of the banking habit, thus reducing the percentage of currency in total M2 from 54.1% in 1955 to 40.0% by 1966. However, the great deal of political unrest experienced in the second phase of development (1967-1972) worked to reverse the previous declining trend of currency/M2. Following the Arab-Israeli War of 1967, the ratio in this year rose to 54.8%. The ratio reached its peak of 63.8% in 1970 when fighting broke out between the Jordanian army and the Palestinian liberation organisations. Finally, the relative degree of political stability prevailed in the last phase of development (1973-1977) helped the ratio to resume its decline as experienced before 1967.

During the last period, the ratio declined gradually to reach 42.9% by 1977 - still higher than the 1966 level. One main reason of the continued high demand for currency is the use of the Jordanian Dinar as a reserve asset in the West Bank of Jordan after the 1967 War. Given the relatively stable value of the Dinar as compared with the Israeli Lira, which has been frequently devaluated, West Bank's Palestinians always showed a strong desire to hold the Jordanian currency, rather than the Israeli's, as an asset to hold. The outflow of the Jordanian Dinar into the West Bank was estimated to form about one third of the total currency outside the banking system.(1)

Another characteristic feature of the structure of domestic liquidity in Jordan (i.e. M2) was the noticeably small relative importance of quasi money, which comprised only 28.2% by 1977. This ratio was very low especially when compared to both developed as well as developing countries included in the sample. As a proportion of total domestic liquidity, quasi money constituted, on average, about two thirds in developed countries, and around one half in developing countries. Only in two countries contained in the sample, Turkey and Peru, was the quasi money ratio lower than that experienced in Jordan (the ratios being 15.9% and 18.1% respectively). The very low level of quasi money in Jordan reflected the high desire of Jordanians to hold very liquid assets in their portfolio; it also meant that the financial system was not successful in lengthening the maturity of deposits offered to the public. The special structure of M2 in Jordan is shown in Figure 3.4 which clearly reveals the noticeable high element of currency and the very small proportion of quasi money during the period 1955 - 1977. As percentages of M2 during this period, the components of currency, demand deposits,

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(1) IMF, Jordan - Recent Economic Development (Feb. 6, 1978) P. 28

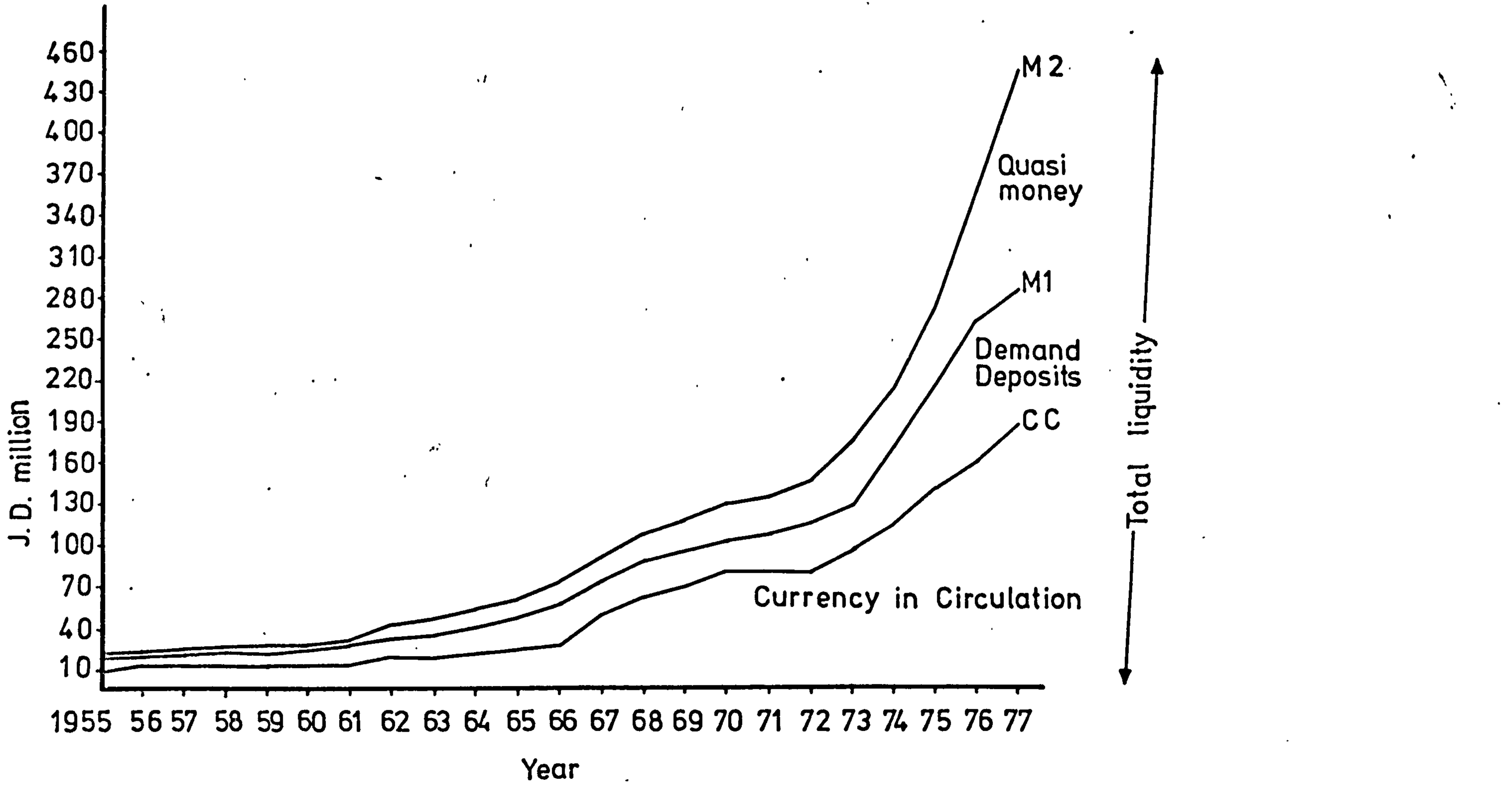


Fig.3-4 Growth and composition of total liquidity in Jordon from 1955 to 1977.
(source: table 3-8)

and quasi money accounted for 51.8%, 28.0%, and 20.2% respectively. This situation has a special implication for the country's economic development because the longer the maturity of the financial assets the larger the ability of utilising such assets for financing development. This is empirically shown in the next section in which currency in circulation is found to be of little significance for Jordan's economic development, whereas quasi money is found to be significantly and highly correlated to real growth. This situation must also call the attention of the monetary authorities to provide means and create conditions conducive to the structural change in domestic liquidity in favour of quasi money, as will be discussed in Chapter 11.

In studying financial development in Jordan, one final point needs illustration. That is, the financial intermediation ratio continued its upward trend even during the last phase of development (73-77), which experienced high inflationary pressures. Despite a high annual rate of inflation averaging 14.4%, the growth of M2 continued to outpace the increase in output, indicating that Jordanians exhibited a noticeably high tendency to hold financial assets even when such assets depreciated sharply in real values because of inflation. The adoption of a low and comparatively stable interest rate policy throughout the whole period further depressed the real return on holding bank deposits into negative levels in recent inflationary years. Table 3.10 illustrates that the average nominal interest rate on bank deposits increased slightly throughout the whole period, rising from 4.0% during 55-66 to 4.2% and 5.2% during 1967-72 and 73-77 respectively. Due to relatively stable prices prevailing during the first phase of development (inflation rate averaging only 1.4% per annum), deposits yielded an average annual positive return of 2.6%. The continued adoption of a low interest rate policy during the second phase of development, which experienced a mild inflation

(annual rise in prices of 4.9%), naturally lowered the real return on holding deposits to a negative average of -0.7%. Although nominal rates

Table 3.10 Nominal and Real Rate of Interest On Bank Deposits, 1955 - 1977

(%)

| Average | Rate of Inflation (1) | Nominal interest rate on bank deposits (2) | Real Return on bank deposits (3 = 2 - 1) | M2/GNP | Quasi Money/ GNP |
|---|---|---|---|---|---|
| 1955-66 | 1.4 | 4.0 | 2.6 | 34.7 | 6.5 |
| 1967-72 | 4.9 | 4.2 | -0.7 | 57.2 | 10.5 |
| 1973-77 | 14.4 | 5.2 | -9.2 | 71.3 | 15.7 |

Source: Chapter 11, Table 11.1, P.352

of interest were slightly increased by an average of 1% during the last period 1973 - 1977, the noticeably high rate of inflation, averaging 14.4% per annum, led to a considerable reduction in the real yield of deposits, which declined to a negative level of -9.2%. However, despite such a high cost in holding deposits, Jordanians continued to exhibit an increasing tendency to hold such assets in their portfolio, as reflected in the rising ratio of M2/GNP (and also by the steady rise in quasi money/GNP as shown by the table).

In conditions of relative price stability, individuals usually tend to distribute their savings among financial and physical assets, guided largely by the net profitability of each type. In inflationary environments, the rising prices work to reduce the real value of money and other financial holdings as compared with physical assets whose value naturally rises with price inflation. The fall in the real value of the financial assets is a tax on their holders whose savings are virtually undermined by inflation. To avoid, or at least to reduce this tax, people seek to change the composition of their investment by

shifting away from financial holdings and towards physical assets.(1) This was what happened in many Latin American countries, such as Argentina, Brazil, and Chile, which experienced a financial decline (M2/GNP decreasing) during the 1960's; people abandoned their financial holdings which increasingly yielded negative return because of strong inflationary pressures.(2) However, this was not the case in Jordan where financial development continued its upward trend during the last inflationary period as discussed earlier.(3) The Jordanian experience was not, however, unique since similar experiences have occurred in many developed and developing countries where people continued to increase their financial holdings even when such assets yielded negative return in real terms.(4) The question remains as to why Jordanians, despite the considerable opportunity cost involved in financial holdings in recent inflationary years, have continued to increasingly acquire this type of asset in their portfolio investment. Such behaviour can be explained by the following three possible reasons:-

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(1) For further details of the effect of inflation on asset portfolio behaviour, see : Graeme Dorrance, "The effect of inflation on economic development", IMF Staff Papers (March 1963) P.3

(2) Ronald McKinnon, Money and Capital in Economic Development, op.cit.P.101

(3) Although there was a clear shift towards physical investments as will be revealed later, financial development (reflected in the M2/GNP ratio) showed a rising trend throughout 73-77.

(4) This was, for example, the case in the U.K., Japan, and India during the period 1965 - 1969. See Anand Chandavarkar, "Some Aspects of Interest Rates Policies in Less Developed Countries", IMF Staff Papers. (March 1971), P.67.

(a) Inflation is only a comparatively recent phenomenon in the Jordanian economy, an economy which has been used to a long period of price stability. Jordanians have not yet adapted the composition of their portfolio balances to appropriately avoid the liquidity cost resulting from high rates of inflation. Consequently, people might have been still deluded by the sharp rises in their nominal incomes, which encouraged them to accumulate further resources in financial form.(1)

(b) As prices rose, people might have consciously felt the need to increase their cash balances in order to retain the same purchasing power of their savings.

(c) A high liquidity preference and a noticeable risk-aversion on the part of many investors led them to accumulate further resources in financial forms, despite their knowledge of the considerable depreciating value of such assets. The element of uncertainty accompanying inflation and the disadvantages of illiquidity attached to long-term fixed investment (including industrial activities) worked together to discourage the already hesitant public to invest in such avenues. The reluctance of this type of investor was particularly accentuated by the previous period of political instability which made their outlook for the future of long-term industrial concerns more obscure. In such unforeseen circumstances, many investors preferred to invest their savings in continuously depreciating financial assets, rather than risking their investment in other unsecured forms.

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(1) Money illusion is defined as observing monetary magnitude (eg. money income) without considering changes in the price level. In the above context, money illusion means treatment of nominal interest rates as real rates. See Peera, Nurali, "Interest Rates: Illusion or Reality", National Westminster Bank, Quarterly Review (May 1970). P.41.

However, it will be argued in Chapter 11 that maintaining a low and conventional interest rate policy is not appropriate for the changing conditions of the Jordanian economy, particularly during inflationary periods. Such a policy might be suitable in an environment of relative price stability where holders of financial assets can yield reasonable rewards for their savings. The monetary authorities should not underestimate the very possible adverse reaction of deposit holders who have been rewarded with negative returns on their savings for many years. If such a situation prevails any longer, it is expected that individuals would adjust their investment pattern in face of high rates of inflation. Money illusion is usually a short-term phenomenon and those who continue to be deluded by nominal monetary magnitudes would soon realise the reality of their financial loss. This would probably lead to a sharp reduction in financial holdings, and a consequent adverse effect on domestic development as experienced in many developing countries. The recent speculative boom in real estate and luxury buildings, particularly during 1972 - 1976, gave a clear example of the unprofitability of financial savings and the willingness of a large part of the public to shift away from financial holdings when the opportunity rose. Clearly, this must have led to a considerable misallocation of resources since a large number of potential investors were indulging in speculative real estate transactions. By raising the real return on financial savings into positive levels, the authorities would encourage people to invest more in such assets, which can be used productively by the financial sector. This would also help to alleviate inflationary pressures because of the expected relative decline in the speculative demand for commodities and other physical assets as people would increase the relative share of their financial holdings.

## III

## The Relationship Between Financial and Real Development in Jordan

Given the emphasis placed on financial institutions within Jordanian development strategy, it is only to be expected that financial development will tend to be closely associated with real growth. It is the aim of this section to examine this relationship, showing how far financial intermediation proceeded with economic growth in the Jordanian context. This will now be established by the application of the simple regression technique.

### (a) The form of the function and the nature of the variables used.

GNP/capita was adopted as a measure for real economic growth. M2/GNP was taken to reflect the degree of financial intermediation.(1) Data were readily available from the IMF (IFS) publications to cover the period 1955 - 1977. The relationship between the two variables is expected to take the following linear form:

$$\text{GNP/capita} = a + b\ (\text{M2/GNP})$$

The above function asserts that an increase in financial intermediation is accompanied by a rise in per capita GNP. As theoretically discussed in Chapter 1, the financial intermediation thesis emphasises the interaction between economic growth and the development of financial institutions without resolving the causality of the relationship. The direction of influence may be both ways. Finance can induce economic growth or vice versa.(2)

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(1) It must be stated here that the published figures for M2 contain a particular peculiarity. Since the occupation of the West Bank in the 1967 war, the Central Bank of Jordan has included an estimate of the deposits held on the West Bank at that time and partially frozen thereafter following the closure of all West Bank branches ever since. In practice, West Bank residents can conditionally withdraw these deposits when visiting the East Bank (because of the 'open bridges' policy). For practical purposes therefore, such deposits can be meaningfully combined to reflect the actual money circulation.

(2) Therefore, whenever the relationship between the two variables is mentioned in the following analysis, it automatically means the two possible directions of influence between economic growth and financial development.

(b) Statistical Analysis.

Relying on the time series approach, an attempt was made to relate GNP/capita to M2/GNP and the following equation was obtained.

$$(1)\quad (GNP/Capita) = 9.9 + 170.0\ (M2/GNP) \qquad R^2 = 0.429$$
$$(3.97)^* \qquad DF = 21$$
$$DW = 0.48$$

The above equation establishes that the coefficient of financial intermediation was statistically significant at the 1% level, with the coefficient sign as hypothesized, It implies that finance was significant in inducing economic development but the degree of correlation was weak as shown by small $R^2$ of 0.429.

Another attempt was made using GDP figures, instead of GNP, on the assumption that the external factors included in the latter might have been insignificant in the process of domestic financial intermediation. It is expected that by employing GDP figures, these external factors would be excluded and a closer relationship between economic growth and financial intermediation can be obtained. Thus, when GDP/capita was examined in relation to M2/GDP, some improvement occurred in the $R^2$, which rose to 0.573, with the t-value of the coefficient of financial intermediation remaining statistically significant at the 1% level (equt. 2)

$$(2)\quad (GDP/Capita) = 20.5 + 113.3\ (M2/GDP) \qquad R^2 = 0.573$$
$$(5.31)^* \qquad DF = 21$$
$$DW = 0.53$$

However, although in equation (2) the financial intermediation ratio explained more of the variation in real growth as shown by the rise in $R^2$, it was believed that the extent to which the two variables were connected was still not strong. Therefore, it was found necessary to discover why, despite the statistically significant influence of financial intermediation, the degree of correlation between the two variables was low.

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* Statistically significant at the 1% level.

As was extensively discussed in the previous section, the broad measure of financial intermediation (M2/GNP) includes both money proper (M1) and near money. The first component is usually demanded for transactions purposes, whereas the second is largely held to satisfy the saving motive. Thus, due to varying reasons for holding both components of the M2, a disaggregated analysis of the financial intermediation ratio may improve the above results. Theoretically, this explanation seems quite reasonable because, given the motivations for holding quasi money and its relatively longer term maturity, one would expect the financial system to utilise such funds for development purposes. Alternatively, economic development may promote an increase in quasi money through the rising levels of incomes and savings. As a result, therefore, quasi money is expected to be closely related to real growth, rather than the very liquid M1 . It was shown in the preceding section that the Jordanian financial intermediation ratio (M2/GNP) was largely constituted from the M1 which accounted for an average of 80% throughout the period 1955 - 1977. Thus, there was a reason to believe that the unsatisfactory degree of connection between M2/GNP and real growth might be related to the special structure of Jordanian M2.

Given the above theoretical explanation, further attempts were made to relate real growth to the two disaggregated components of the M2/GNP and the results are shown below:

(3) M1: (GNP/Capita) = 19.8 + 188.6 (M1/GNP) $R^2$ = 0.300
(3.00)* DF = 21
DW = 0.41

(4) Quasi Money: (GNP/Capita) = 12.2 + 797.9 (Q/GNP) $R^2$ = 0.740
(7.86)* DF = 21
DW = 0.73

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* Statistically significant at the 1% level.

Equations 3 and 4 clearly fit the above theoretical justification of the relatively poor correlation between the broad measure of financial intermediation and economic growth. Equation 3 makes it abundantly clear that although the coefficient of the M1/GNP ratio was still statistically significant in inducing a change in real growth, the degree of correlation between the proper money/GNP ratio and growth was very poor ($R^2 = 0.300$). When regressing GNP/capita on quasi money/GNP, a noticeable improvement in the level of $R^2$ occurs with the t-value of the coefficient remaining statistically significant at the 1% level, (Equation 4). $R^2$ rises to 0.740, revealing that financial intermediation, represented in the relatively longer-term and more stable component of the M2, explains about three quarters of the change in real growth. This is compared with $R^2$ value of 0.429 in equation (1), when growth was examined in relation to the aggregated measure (M2/GNP). The discrepancy between the two values of $R^2$ means that when the two components of the financial intermediation ratio are taken together, the degree of correlation between economic growth and financial intermediation is partly weakened by the poor connection between M1 and growth (as shown when M1 and quasi money were examined separately). However, the disaggregation of the financial intermediation process yields even better results when GDP figures are employed instead of GNP's (this also happened in equation 2). As shown below, the $R^2$ values rise in both equations with the coefficients' t-values remaining statistically significant in inducing the variation in real growth.(1)

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(1) The rest of the determination of growth in Equation 6 can be explained by other factors, such as the fiscal policy. As shown in Section I of this Chapter, public investment contributed importantly to gross capital formation. See P.51

(5) M1 : (GDP/Capita) = 23.4 + 136.6 (M1/GDP) $R^2$ = 0.453
(4.17)* DF = 21
DW = 0.47

(6) Quasi money: (GDP/Capita) = 28.7 + 469.8 (Q/GDP) $R^2$ = 0.816
(9.66)* DF = 21
DW = 0.87

A further disaggregation of M1 between currency in circulation and demand deposits reinforces the above argument that the structure of the Jordanian financial intermediation ratio was a significant factor in influencing real growth. Although both components of the M1 are usually held for transactions purposes, one would expect demand deposits to be more related to economic growth as compared with currency in circulation, which are kept idle outside the financial system. This was found empirically true as equations 7 and 8 read:

(7) Currency in Circulation: (GNP/Capita) = 47.1 + 1.8 (CC/GNP) $R^2$ = 0.171
(2.00) DF = 21
DW = 0.29

(8) Demand Deposits : (GNP/Capita) = 26.1 + 4.7 (dd/GNP) $R^2$ =0.308
(3.06)* DF = 21
DW = 0.72

Equation (7) shows that the response of real growth to a unit change in currency in circulation is statistically insignificant, $R^2$ also reveals a very low value of 0.171, reflecting a poor correlation between growth and the currency element. When the latter is excluded from the M1, better results are obtained in both the t-value of the coefficient and the degree of determination (equation 8). The coefficient of the demand deposits was found statistically significant in determining growth, though explaining only a small percentage of changes in GNP/capita.

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* Significant at the 1% level.

## Summary of the Main Findings and Conclusions:

The preceding analysis in this section attempted to relate growth in the real economy to financial development in the Jordanian case. The relationship was examined with the aid of simple regression techniques. The main findings are summarised as follows:-

1. Financial intermediation was significant in determining the real growth in the Jordanian economy. The response of real growth to a unit change in financial intermediation was found statistically significant at the 1% level.

2. Although the above analysis clarified that financial development progressed with real growth, it did not resolve the causality of the relationship. This was difficult to reveal empirically. As was discussed in Chapter 1, the direction of the causal relationship may run both ways: financial intermediation can influence economic growth mainly through encouraging savings in financial forms, reducing the cost of investment, and improving the allocation pattern of resources; while econonic development may induce the development in the financial sector through raising the levels of incomes and savings and enlarging the scope for investment opportunities. However, although the direction of the influence of the relationship between the two variables has not yet been clarified, attempts are made in the following chapters to illustrate this point when the role of each type of intermediary is discussed.

3. Despite the statistically significant influence of M2/GNP on real growth, this broad measure of financial intermediation was able to explain only less than half of the variation in per capita GNP. It is believed that this poor correlation might be due to the special structure of the Jordanian M2 with the high element of M1. This was found quantitatively true. When M1 was excluded, the quasi money/GNP ratio yielded good results. Some further improvements occurred when GDP figures were employed instead of GNP's. The coefficient of the quasi money/GDP ratio remained statistically significant at the 1% level with the $R^2$ explaining 82% of GDP/Capita variation.

4. The above statistical test proves the fact that the longer the maturity of the financial asset, the greater the link between finanical intermediation and development. This was not only illustrated by the high correlation between real growth and the relatively more stable quasi money, but it was further clarified when the GNP/capita was related to the disaggregated components of the M1. Currency in circulation was found to be very weakly related to economic growth with $R^2$ accounting for only 0.171 of the variation. Demand deposits/GNP exhibited a higher correlation ratio of 0.308. This was higher than the $R^2$ of the M1/GNP because the very low performance of currency in circulation adversely influenced the general performance of the M1/GNP. M2/GNP came next with $R^2$ registering 0.429. When the currency element was dropped from M2, (quasi money + demand deposits)/GNP yielded a noticeably higher $R^2$ of 0.698. Finally, when quasi money was taken separately, it gave the best $R^2$ of 0.746. The same order of development occurred when GDP figures were used, giving higher $R^2$ value for each independent variable. A summary of these results is given in Table 3.11 which classifies the independent variables employed in the analysis in accordance with their relative liquidity. As is clearly shown by the table, $R^2$ values increase with a rise in the relative illiquidity of the financial asset.

5. The finding in 4 indirectly emphasises the significance of the financial assets held by the non-bank financial institutions which deal mainly in long-term financial instruments. Although the adopted measure of financial intermediation was largely confined to the banking system because of data constraint,[1] the strong connection between real growth

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(1) Apart from one non-bank financial institution (Housing Bank) whose deposits were included in the M2 figures. (see P.67).

Table 3.11 Regressions of Changes in Domestic Financial Intermediation (aggregated and disaggregated ratios) on Real Growth in the Jordanian Economy, 1955 - 1977

DF = 21

| Independent Variables | Constant Term | Reg. Coeff. | t-Value | $R^2$ | DW |
|---|---|---|---|---|---|
| I. GNP Data | | | | | |
| 1. CC/GNP | 47.1 | +1.8 | (2.00) | 0.171 | 0.29 |
| 2. M1/GNP | 19.8 | +188.6 | (3.00)* | 0.300 | 0.41 |
| 3. DD/GNP | 26.1 | +4.7 | (3.06)* | 0.308 | 0.72 |
| 4. M2/GNP | 9.9 | +170.7 | (3.97)* | 0.429 | 0.48 |
| 5. Q + DD/GNP | 9.3 | +4.4 | (6.97)* | 0.698 | 0.96 |
| 6. Q/GNP | 12.2 | +797.9 | (7.86)* | 0.746 | 0.73 |
| II. GDP Data | | | | | |
| 7. CC/GDP | 37.9 | +1.5 | (3.17)* | 0.324 | 0.35 |
| 8. M1/GDP | 23.4 | +136.6 | (4.17)* | 0.453 | 0.47 |
| 9. DD/GDP | 26.1 | +4.7 | (3.06)* | 0.508 | 0.72 |
| 10. M2/GDP | 20.5 | +113.3 | (5.31)* | 0.573 | 0.53 |
| 11. Q + DD/GDP | 18.7 | +2.4 | (6.63)* | 0.735 | 0.86 |
| 12. Q/GDP | 28.7 | +469.8 | (9.66)* | 0.816 | 0.87 |

* All Reg. Coeff. are significantly different from zero at the 1% level.

DW < 2 implies positive autocorrelation.

and the long-term nature of the financial asset can be also indicative to the significance of the non-bank financial sector in development.

6. Finally, the above results have very important implications for economic development and the role of financial intermediation in the development process. The strong correlation between quasi money and real growth should further attract the attention of the monetary authorities to the small relative weight of this component in the M2 structure. One major concern of the Central Bank of Jordan should be to provide means and create conditions capable of inducing a structural transformation of financial savings in favour of longer-term maturity.

Having established in the first three chapters the theoretical and applied framework within which the Jordanaian financial system has operated and must be viewed, it is now necessary to investigate the development roles played by the component parts of the financial system, beginning with that of the commercial banking system in Part B, and continuing in Part C with that of the non-bank financial institutions, and concluding in Part D with that of the Central Bank and an assessment of monetary and banking techniques and innovations.

# PART B

## THE COMMERCIAL BANKING SYSTEM

CHAPTER 4

# COMMERCIAL BANKING ACTIVITY AND ECONOMIC DEVELOPMENT IN JORDAN, 1964 - 1977

The activitiesof commercial banks are best analysed by reference to their balance sheets, which can reveal how efficient they are as financial intermediaries specialising in the mobilisation of funds from various sources and allocating these funds between alternative uses. This type of analysis must however have reference to the rules and constraints on their operations placed by the system of legislative regulation in Jordan since the Banking Law of 1959.

Since independence and up to 1959, commercial banks were completely free to undertake business and were not subject to any special law regulating their operations. Throughout this period, commercial banks operated in accordance with the "Law of Companies" which applied to other commercial and industrial firms. The absence of any banking law during this period can be explained by the lack of an independent monetary authority with discretionary power to regulate and influence bank activities. The system was still regulated by the Currency Board which was itself precluded by law from practising any banking functions. It was therefore no coincidence that the introduction of the first law regulating banks was concomitant with the creation of an independent monetary authority vested in a central bank. Thus, Law No. 4 of establishing the Central Bank of Jordan (CBJ) was issued in 1959. In this year also, commercial banks became subject to Banks Control Law No. 5 as published in the official Gazette.(1)

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(1) The Official Gazette, (Feb. 14, 1959) P.161

Since the CBJ did not effectively start operations until 1964, the Minister of Finance was given executive powers for the application of this Law, including issuing licences for banks to undertake business in the Country, after consultation with the CBJ's Board of Directors. The Law comprised 21 articles regulating bank business and forbidding them to undertake certain activities. In practice, however, this Law was non-operative due to the absence of a central bank.(1) Effective banking control did not start until 1966, some two years after the CBJ had commenced its operations, and had subsequently enacted Temporary Banking Law No. 94. The two years of initial central banking experience made this new Law more realistic and adapted to the special domestic environment within which commercial banks had to function. According to this Law, all powers which were previously given to the Minister of Finance, regarding control over banks, were transferred to the CBJ which now became the sole authority responsible for licensing banks. As will be shown later, the new Law was both more specific in controlling bank investment behaviour and regulating the volume and composition of their liquid assets, and yet more 'liberal', as it introduced some relaxation in and modifications to the prohibited areas which had previously restricted bank activities. There were six main business areas which commercial banks were forbidden to undertake(2).

(1) A bank cannot extend credit or guarantee to any customer more than 25% of its paid-up capital and reserves. The ratio can be raised only if the approval of the CBJ is obtained. Excluded from this restriction are inter-bank transactions or facilities granted against letters of

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(1) Alawin, A. A. The Role of the Commercial Banks in the Economic Development in Jordan, M. A. Thesis, op.cit. P.52

(2) The"Temporary Banking Law ", No. 94, Part 3, Article 11

credit or bills or documents payable in foreign exchange. The above ratio was fixed by the 1959 Law at a maximum of 20%.

(2) A bank cannot extend any credit facilities against the security of its own shares. Moreover, unsecured credit facilities cannot be granted to any member of a bank's board of directors in excess of JD 1,000, or to any employee in excess of half his annual salary. These restrictions can be removed after the approval of the CBJ.

(3) A bank cannot engage on its own account, or on a commission basis, in wholesale or retail trade including foreign trade.

(4) A bank's maximum investment in any industrial, agricultural or commercial project should not exceed 25% of its paid-up capital and reserves.(1) Excluded from this restriction, however, is bank investment in local institutions contributing to economic development. The above ratio was fixed by the 1959 Law at a maximum of 15%.

(5) A bank's loans secured by the real estate should not exceed 40% of its total deposits unless the bank specialises in mortgages, providing it gains the CBJ's approval.(2)

(6) A bank's holdings of foreign exchange became no longer free and should be subject to limits and conditions specified by the CBJ.

However, although the Temporary Banking Law of 1966 was more realistic than the previous Law, the rapid development of the Jordanian economy, particularly the financial sector, necessitated new amendments to this Law. Consequently, two amending laws were passed in 1971 and 1975 (i.e. The Banking Law No. 24 of 1971, as amended by the Provisional Law No. 5 of 1975), which are, at present, governing bank activities in Jordan.

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(1) The maximum ratio was raised in accordance with Law No. 24 of 1971 to 75%.

(2) This article was placed in the amending Law of 1971 by a new article which stipulates that any bank should not extend mortgage loans in excess of 20% of its deposits unless it is a specialised mortgage bank.

## Sources of Bank Funds

### 1964 - 1977

Table 4.1

(In millions of JD)

| Years | Domestic Sources | | | | | | | | | | Foreign Sources | | | | | | | | Total Bank Funds | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Capital & Reserves | | Deposits | | | | | | Balances held for Banks | | Total | | Loans from and Balances held for Banks abroad | | Deposits of non-resident | | Loans from the CB and local Banks | | Other | |
| | | | Private | | Public | | Total | | | | | | | | | | | | | |
| | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % |
| 1964 | 4.67 | 7.3 | 28.16 | 44.0 | 19.66 | 30.7 | 47.82 | 74.8 | 3.11 | 4.9 | 61.24 | 95.7 | 1.08 | 1.7 | 1.64 | 2.6 | - | - | 5.64 | 8.8 |
| 1965 | 5.12 | 8.6 | 35.76 | 59.6 | 6.36 | 10.6 | 42.12 | 70.2 | 1.68 | 2.8 | 56.69 | 94.5 | 1.34 | 2.2 | 1.98 | 3.3 | - | - | 7.77 | 12.9 |
| 1966 | 6.14 | 8.7 | 44.46 | 63.3 | 6.23 | 8.8 | 50.69 | 72.1 | 1.02 | 1.6 | 67.39 | 95.9 | 0.73 | 1.0 | 2.15 | 3.1 | 0.05 | - | 9.49 | 13.5 |
| 1967* | 6.39 | 9.0 | 40.63 | 57.4 | 10.63 | 15.1 | 51.26 | 72.5 | 0.69 | 1.0 | 68.16 | 96.3 | 0.51 | 0.7 | 2.13 | 3.0 | - | - | 9.82 | 13.8 |
| 1968 | 7.20 | 6.1 | 42.91 | 60.2 | 9.42 | 13.2 | 52.33 | 73.4 | 0.87 | 1.3 | 68.68 | 96.4 | 0.72 | 1.0 | 1.85 | 2.6 | - | - | 8.28 | 11.6 |
| 1969 | 7.89 | 10.6 | 45.32 | 60.7 | 9.54 | 12.7 | 54.86 | 73.4 | 0.35 | 0.4 | 71.42 | 95.6 | 0.76 | 1.0 | 2.54 | 3.4 | - | - | 8.32 | 11.2 |
| 1970 | 7.98 | 10.4 | 43.45 | 56.9 | 11.70 | 15.3 | 55.15 | 72.2 | 1.48 | 1.9 | 72.88 | 95.4 | 1.00 | 1.3 | 2.52 | 3.3 | 0.26 | 0.3 | 8.01 | 10.6 |
| 1971 | 8.02 | 9.8 | 48.82 | 59.4 | 8.75 | 10.6 | 57.57 | 74.0 | 5.93 | 7.2 | 79.70 | 97.0 | 0.42 | 0.5 | 2.08 | 2.5 | 0.69 | 0.8 | 7.49 | 9.2 |
| 1972 | 8.02 | 8.3 | 61.23 | 64.1 | 9.62 | 10.1 | 70.85 | 74.2 | 5.30 | 5.5 | 93.09 | 97.4 | 0.40 | 0.4 | 2.04 | 2.2 | 0.31 | 0.4 | 8.61 | 9.0 |
| 1973 | 8.01 | 7.2 | 73.31 | 65.7 | 10.30 | 9.2 | 83.61 | 74.9 | 5.12 | 4.6 | 109.00 | 97.7 | 0.46 | 0.4 | 2.14 | 1.9 | 0.23 | 0.2 | 12.03 | 10.8 |
| 1974 | 9.50 | 6.6 | 95.58 | 66.7 | 12.77 | 8.9 | 108.35 | 75.6 | 5.82 | 4.2 | 138.99 | 97.0 | 0.63 | 0.4 | 3.63 | 2.6 | 0.41 | 0.2 | 14.91 | 10.4 |
| 1975 | 12.29 | 5.8 | 132.92 | 62.3 | 16.49 | 7.8 | 149.41 | 70.1 | 11.17 | 5.2 | 202.86 | 95.2 | 1.71 | 0.8 | 8.63 | 4.0 | 2.85 | 1.3 | 27.14 | 12.8 |
| 1976 | 14.90 | 4.9 | 190.74 | 63.3 | 18.85 | 6.2 | 209.59 | 69.5 | 12.72 | 4.3 | 277.61 | 92.1 | 6.24 | 2.1 | 17.65 | 5.8 | 0.27 | - | 40.13 | 13.4 |
| 1977 | 20.68 | 5.6 | 245.78 | 66.9 | 20.97 | 5.7 | 266.75 | 72.6 | 16.10 | 4.4 | 348.05 | 94.7 | 2.28 | 0.7 | 17.06 | 4.6 | 1.09 | 0.3 | 43.43 | 11.8 |
| Av. % 64-77 | | 7.8 | | 60.8 | | 12.0 | | 72.8 | | 3.5 | | 95.8 | | 1.0 | | 3.2 | | 0.3 | | 11.4 |

Source: (1) Central Bank of Jordan, The Annual Report, (1966, 1971)

(2) _____, Monthly Statistical Bulletin, (June 1977; December 1978)

* From May 1967 onwards, data were estimated for bank branches in the occupied West Bank.

Given this legislative framework, how then did bank activities develop throughout the period 1964 - 1977? This is shown by the following analysis of commercial banks' sources and uses of funds. Within this analysis, their fundamental role as mobilisers and allocators of funds is examined.

## I. Sources of Funds

The role of the commercial banks in the task of economic development depends primarily on their resources and the extent to which they are able to mobilise the community's savings, and other idle funds. An examination of Table 4.1 reveals, that the bulk of bank funds in Jordan came from domestic sources which comprised, on average, 95.8% of total bank funds throughout the period 1964 - 1977. The relatively small share of foreign sources can be mainly explained by, firstly, the weak position of Jordan as a financial centre capable of attracting a considerable inflow of financial resources and, secondly, the restrictions imposed by bank legislation as regard to foreign exchange transactions. As far as deposits are concerned, commercial banks were forbidden to accept any deposit in currencies other than the Jordan dinar. This legislation further discouraged commercial banks in their efforts to attract foreign capital. However, some relaxations to the Law were introduced in 1973 when the CBJ allowed the commercial banks to accept deposits in foreign currencies from Jordanians working abroad and from non-residents.(1) These deposits were favourably treated as they can be withdrawn at any time without the prior approval of the CBJ, and regardless of any foreign exchange restrictions. Moreover, they constituted a profitable investment outlet since they were offered high rates that were competitive with interest rates prevailing on the international

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(1) The CBJ, Tenth Annual Report, 1973, P.62

financial markets. This procedure led to an increase in the relative importance of foreign sources in total bank funds from 2.3% in 1973 to 5.3% by 1977.

Capital and Reserves. Of domestic sources, internal capital and reserves represented,on average, some 7.8% of total bank funds during the period under review. Banks are legally required to provide a specified minimum capital before starting business. These prudential requirements have been subject to successive amendment: the 1959 Law specified these levels as JD 250,000 for local banks and the equivalent of JD 500,000 for foreign banks, whereas both local and foreign banks became subject to unified minimum requirements under the Temporary Banking Law of 1966, which were fixed at JD 250,000. This was raised to JD 500,000 (for both types of banks) when the provisional Law of 1975 came into effect. The increase was necessitated by the spectacular increase in deposits which resulted in declining the capital to deposit ratio.(1) Increasing active capital requirements was considered necessary to protect the rights of both depositors and shareholders, and to ensure and strengthen the banks' financial position.(2) As a result of this procedure, and due to the entry of two new banks into banking in 1975, the capital and reserves of commercial banks increased in absolute terms from JD 9.50 million in 1974 to JD 12.29 million in 1975. Despite this increase, however, the relative contribution of this item to total bank funds showed a continuous decline throughout the whole period, decreasing from 7.3% in 1964 to 5.6% in 1977. This decline can be related to the rapid increase in deposits which comprised the main source of bank funds.

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(1) CBJ, Twelfth Annual Report, 1975, P.36

(2) Ibid.

Bank Deposits. The same table makes it clear that bank deposits (domestic as well as foreign) comprised, on average, about three quarters of total funds during the period under review, thus giving one main feature of commercial banks as financial intermediaries depending on their operations on funds mobilised from different economic units. The increase was mainly concentrated in the deposits of the resident private sector which increased in relative importance of total bank funds from 44.0% in 1964 to 66.9% by 1977. These deposits showed a steady increase over the whole period with the exception of 1967 and 1970: the years which witnessed heavy withdrawals from the banks because of the unsettled political circumstances. As is shown by the table, these deposits decreased from JD 44.46 million in 1966 to JD 40.63 million in 1967, and from JD 45.32 million in 1969 to JD 43.45 million in 1970. As a compensatory procedure, the government deposited more funds with the commercial banks in both ... years, thus increasing its deposits from JD 6.23 million in 1966 to JD 10.63 million in 1967; and from JD 9.54 million in 1969 to JD 11.70 million in 1970. As far as government deposits are concerned, it is worth noting here that these deposits used to comprise an important source of bank funds before the establishment of the CBJ in 1964. Their relative importance declined considerably after that year as the government transferred the bulk of its funds to the CBJ, which acts as its official banker. The table indicates that while these deposits formed 30.7% of total bank funds in 1964, their relative importance decreased to 10.6% in 1965, and continued to decline to form only 5.7% by 1977.

Borrowing from the Central Bank. Banks' resort to the CBJ as an ultimate source of liquidity was insignificant as is shown by the very low share of this item in total bank funds, the ratio comprising only 0.3% throughout the whole period. This behaviour indicates the high liquidity

of the commercial banks which made it unnecessary for them to resort to the CBJ for additional funds.

As has been already observed, the private sector's deposits held with the commercial banks formed the bulk of bank resources; therefore, a further examination of their structure and nature is essential for the later discussion of their role in financing economic development.

Commercial banks in Jordan offer to the public three types of deposit facilities, i.e. demand, time, and saving deposits. Table 4.2 shows that demand deposits comprised more than half total deposits, their relative share varying slightly from year to year and averaging around 52.5% throughout the whole period. These deposits differ from other types of deposits and claims because they are highly liquid and represent a chief medium of payments. This function of demand deposits gives the commercial banks a unique position among other financial intermediaries as being responsible for a great part of the payments mechanism. However, it is interesting to note that, unusually, demand deposits in Jordan are interest-bearing, just like other types of deposits. It will be shown in the following chapter that rising competition for deposits between commercial banks, particularly after 1973, led to the offering of interest on demand deposits, near to those offered on savings and time deposits. During the period 1973 - 1977, the rate of interest paid on demand deposits averaged 4.52%.(1)

The same table shows that time deposits came second in importance, with an average ratio to total deposits of 33.9% throughout the whole period. These deposits are either due on a fixed date or they are withdrawable subject to an agreed period of notice. Interest paid on

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(1) CBJ, Monthly Statistical Bulletin (July 1978) Table 13

## Table 4.2 Composition of Private Sector's Deposits* Held with Commercial Banks 1964 - 1977

(In millions of JD)

| Years | Demand Deposit | | Time Deposit | | Saving Deposit | | Total Deposit | | Average Annual Rate of Increase | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Demand | % Time | Saving |
| 1964 | 15.75 | 52.9 | 10.96 | 36.8 | 3.08 | 10.3 | 29.79 | 100.0 | - | - | - |
| 1965 | 20.01 | 53.0 | 13.70 | 36.3 | 4.03 | 10.7 | 37.74 | 100.0 | 27.0 | 25.0 | 30.8 |
| 1966 | 25.94 | 55.7 | 16.52 | 35.5 | 4.13 | 8.8 | 46.59 | 100.0 | 29.6 | 20.6 | 2.5 |
| 1967 | 24.06 | 56.3 | 15.07 | 35.2 | 3.63 | 8.5 | 42.76 | 100.0 | -6.3 | -8.8 | -12.2 |
| 1968 | 24.21 | 54.1 | 16.67 | 37.2 | 3.88 | 8.7 | 44.76 | 100.0 | - | 10.6 | 6.9 |
| 1969 | 24.86 | 51.9 | 18.23 | 38.3 | 4.77 | 9.8 | 47.86 | 100.0 | 2.7 | 9.3 | -3.0 |
| 1970 | 22.56 | 49.1 | 17.58 | 38.2 | 5.84 | 12.7 | 45.98 | 100.0 | -10.0 | -3.6 | 54.9 |
| 1971 | 24.27 | 47.7 | 19.31 | 38.0 | 7.30 | 14.3 | 50.88 | 100.0 | 7.5 | 9.8 | 25.8 |
| 1972 | 32.30 | 51.1 | 21.46 | 33.9 | 9.51 | 15.0 | 63.27 | 100.0 | 33.1 | 11.1 | 30.3 |
| 1973 | 39.09 | 51.8 | 23.97 | 31.8 | 12.39 | 16.4 | 75.45 | 100.0 | 21.0 | 11.7 | 30.3 |
| 1974 | 52.41 | 52.8 | 30.91 | 31.2 | 15.89 | 16.0 | 99.21 | 100.0 | 34.1 | 29.0 | 28.2 |
| 1975 | 79.58 | 56.2 | 39.50 | 27.9 | 22.46 | 15.9 | 141.54 | 100.0 | 51.8 | 27.8 | 41.3 |
| 1976 | 108.89 | 52.2 | 53.32 | 25.6 | 46.18 | 22.2 | 208.39 | 100.0 | 36.8 | 35.0 | 105.6 |
| 1977 | 132.03 | 50.2 | 77.69 | 29.5 | 53.12 | 20.3 | 262.84 | 100.0 | 21.2 | 45.7 | 15.0 |
| Av. 64-77 | | 52.5 | | 33.9 | | 13.6 | | 100.0 | 20.2 | 15.9 | 25.5 |

Source: (1) The Central Bank of Jordan, Statistics Pertaining to some Aspects of the Jordanian Economy (Amman: Central Bank Publications, October 1974).

(2) The Central Bank of Jordan, Monthly Statistical Bulletin (Feb.79)

* Both resident and non-resident. Non-resident figures include amounts of deposits of foreign agencies, which are only a small percentage of the total as shown in Table 4.1

time deposits was slightly higher than that offered on demand deposits, averaging 5.73% between 1973 - 1977.(1) The same table shows that the relative size of this type of deposits in the deposit structure declined noticeably during the period under review, decreasing from 36.8% in 1964 to 29.5% by 1977. This was owing to the notable rise in saving deposits.

Saving deposits registered the highest rate of growth as compared with the above two types of deposits. Given an average annual rate of growth of 25.5%, these deposits increased their contribution to total bank deposits from 10.3% in 1964 to 20.3% by 1977. The largest increase in saving deposits occurred in 1976, when in that year alone they more than doubled, increasing from JD 22.46 million to JD 46.18 million. This remarkable increase can be partly explained by rising money incomes and partly by a slight increase in the interest rate paid on these deposits, which rose from 4.50% in 1975 to 5.25% in 1976.(2) This was further increased to 5.50% by 1977.(3)

In differentiating between types of deposits, it can be said that saving deposits are similar, in one respect, to demand deposits, whereas in another respect, they can be considered as time deposits. The similarity between demand and saving deposits stems from the fact that they are both withdrawable without an advance notice; but they are different in that the latter cannot be used as means of payments. The holder of saving deposits cannot draw a cheque on his account and he can only withdraw money if he cashes it himself over the counter of his bank. It is for this latter aspect that saving deposits are considered similar to time deposits and, sometimes, they are both grouped within one

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(1) Ibid.

(2) Ibid.

(3) Ibid.

category as distinct from demand deposits.(1) Both time and saving deposits represent the less liquid claims on commercial banks. These deposits have generally a more stable character as compared with the more volatile demand deposits. Their large relative size in total bank deposits, combined with their non-fluctuating character, have been used in many countries as a base for extending bank activities into medium and long-term business. As will be shown later in this chapter, the implications of term lendinghave a special bearing in developing countries, which are experiencing an increasing demand for such type of credit necessitated by launching comprehensive development programmes. The argument for term lending undertaken by commercial banks is further encouraged in the particular case of Jordan because of the relatively low rate of turnover of demand deposits. As can be seen below, demand deposits in Jordan have special features which work to lower their annual velocity. Part of these deposits is kept on demand without being actively used, thus reflecting a disguised form of saving deposits which commercial banks can rely on in extending longer-term credit.

The term 'turnover' or 'velocity' of demand deposits indicates how many times these deposits have been used in a specific period of time. To obtain this figure, one can divide the total debits of the banks over one year by the corresponding volume of demand deposits.(2) As is the case in many developed and developing countries, figures for bank debits are not available in Jordan; therefore, it is necessary to adopt

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(1) The IMF classifies both types of deposits under one heading as distinct from the more fluid demand deposits.

(2) Bank debits figures measure the extent to which depositors are using their checking accounts. For this measure of velocity, see: The Federal Reserve System, Federal Reserve Bulletin (Washington, D.C.: July 1972) PP. 631 - 635

another appropriate method to measure the velocity of demand deposits. Bank clearings can be used here to serve this purpose. Clearing activities do not, however, give as accurate figures as the previous measure because they do not take into account two matters: firstly, clearings within the bank itself (or between different branches of the same bank) and, secondly, the volume of cash withdrawals on these deposits direct from the banks' counters. In order to obtain accurate figures indicating how many times these deposits are used in a year, the above two channels should be taken into consideration. The volume of deposits which could be used through these channels was estimated to form about half of total bank clearings.(1) By increasing total clearings 50%, therefore, more accurate figures for the total use of demand deposits are now obtained.

Table 4.3 demonstrates the annual turnover of demand deposits in selected developed and developing countries during the period 1965 - 1976.(2) One striking feature of this table is the distinct difference in turnover figures between the two groups of countries.(3) Given the fact that demand deposits are largely used as the main medium of payments in developed countries, it is expected that such deposits would have a higher rate of turnover as compared with less developed countries. In the U.S.A., for example, demand deposits experienced high turnover, averaging around 66.7 a year during the period under review. This means that these deposits were used, on average, once every five days, or

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(1) This was estimated with the help of staff of some commercial banks during the Author's field study visit to Jordan in the Summer 1978.

(2) The analysis here does not cover the year 1977 because figures for this year regarding other countries included in the table have not yet been published.

(3) See Figure 4.1

Table 4.3 Demand Deposits Turnover in Selected Developing and Developed Countries,* 1965 - 1976

Ratio

| Years | Developing Countries | | | | Developed Countries | | |
|---|---|---|---|---|---|---|---|
| | Jordan** | Iraq | Libya | Ghana | U.S.A. | Germany | Japan |
| 1965 | 6.1 | 25.2 | 27.6 | 23.6 | 37.0 | 37.0 | 40.6 |
| 1966 | 6.9 | 25.0 | 29.7 | 22.5 | 42.2 | 55.5 | 40.4 |
| 1967 | 7.3 | 24.4 | 31.7 | 21.5 | 43.9 | 50.6 | 41.9 |
| 1968 | 7.5 | 24.1 | 32.2 | 23.0 | 48.4 | 55.0 | 44.4 |
| 1969 | 7.8 | 21.9 | 37.8 | 17.4 | 53.2 | 62.5 | 43.8 |
| 1970 | 7.8 | 20.3 | 18.1 | 24.8 | 57.8 | 68.3 | 46.7 |
| 1971 | 8.1 | 15.3 | 12.0 | 25.2 | 63.4 | 64.0 | 39.6 |
| 1972 | 7.8 | 14.8 | 16.0 | 20.9 | 66.2 | 61.0 | 38.4 |
| 1973 | 8.8 | 14.4 | 18.4 | 17.6 | 79.2 | 69.9 | 44.2 |
| 1974 | 9.5 | 14.4 | 19.4 | 22.5 | 95.9 | 67.6 | 50.2 |
| 1975 | 11.2 | 13.7 | 19.6 | 17.4 | 100.9 | 69.6 | 53.4 |
| 1976 | 14.4 | 14.6 | 14.4 | 16.1 | 112.4 | 69.5 | 50.7 |
| Average 65-76 | 8.6 | 19.0 | 23.1 | 21.0 | 66.7 | 60.8 | 44.5 |

Source : (1) Appendix 4.1
(2) Appendix 4.2

* Since an appropriate method of computing turnover of demand deposits is to divide total bank debits by the volume of deposits, it is proposed here to select, for the purpose of comparison, some developing and developed countries which publish bank debits figures in their financial statistics. Countries which publish only bank clearings statistics are excluded because it is difficult to estimate, in each individual case, the amount of clearings occurring within one bank and the direct encashment over the banks' counters.

** Turnover figures are computed for Jordan by dividing bank clearings (adjusted figures) by the volume of demand deposits. (See P.101)

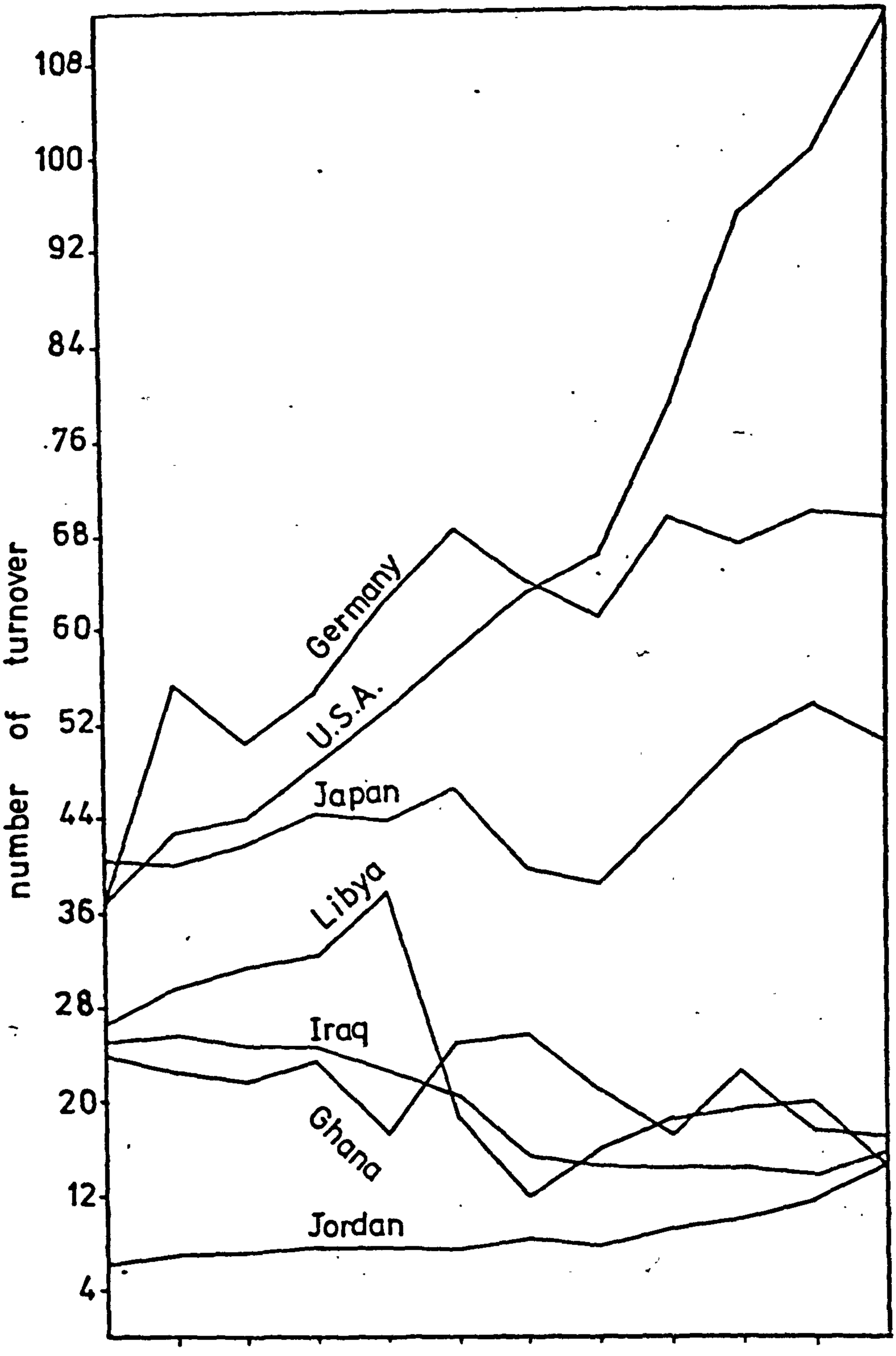


Fig. 4-1 Demand deposit turnover in selected developed and developing countries from 1965 to 1976. (source: table 4-3 )

about six times a month.(1) Germany and Japan also experienced high turnover figures of 60.8 and 44.5 respectively. On the other hand, the table reveals that developing countries showed a relatively low rate of turnover for their demand deposits. Out of these countries covered in the table, Jordan experienced the lowest turnover, accounting for 8.6 a year. This means that, on average, demand deposits were used in Jordan once every one month and twelve days(2) - this is particularly low when compared with averages of 19.0 for Iraq, 23.1 for Libya and 21.0 for Ghana. However, the table illustrates that the Jordanian turnover figures more than doubled during the period under review, increasing from 6.1 in 1965 to 14.4 in 1976. This rise, particularly since 1973, can be explained by a higher rate of growth in the economy as a result of the launching of development programmes. A rise in the level of aggregate expenditure on goods and services activates and swells the volume of Cheques drawn on demand deposits and thus increases their velocity. This has been further accentuated by the recent high inflationary pressures which effectively increased the cost of domestic transactions and thus the volume of deposits withdrawn from the banks.

The relatively low turnover of demand deposits in Jordan means that these deposits are not used by their owners as much as they are used in countries with higher turnover figures. Apart from common factors which are generally behind the low turnover of demand deposits in developing countries, such as the relative underdeveloped stage of the banking habit, there seem to be three particular reasons for the continued relative reduction of the Jordanian ratio compared with other countries -

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(1) $\frac{12}{66.7}$ = 0.18 month = 5.4 days.

(2) $\frac{12}{8.6}$ = 1.4 month = 42 days.

(1) Since demand deposits in Jordan earn interest, these deposits are kept on demand not only to settle current transactions, but also as an investment outlet. This accordingly lowers the annual turnover of such deposits.

(2) Influenced by the traditional belief of a significant part of the Moslem population who regards interest on borrowed money as usury , large amounts of demand deposits are held not only for transaction purposes, but as a convenient way to hold individuals' savings. Many people who still believe interest to be usury ; and who look towards banks as a safe place for keeping money, try to avoid such suspicion by depositing their funds in the banks without receiving any interest.(1) As they do not accept interest, it does not matter for those people whether their funds are deposited on demand or saving account. They may even find it more convenient and less complicated to hold their savings on demand accounts. This part of the demand deposits is kept with the banks without any active use as would otherwise be the case if these deposits are deposited on demand to settle current payments. This also works to lower the velocity of demand deposits.

(3) In Jordan, as in many developing countries, people tend to keep part of their funds on demand as a precautionary procedure against unforeseen emergencies, such as unemployment, illness...etc. In the more developed countries, people display less incentive to keep part of their funds for such purposes because these aspects are covered by active social security programmes. This situation further lowers the turnover of demand deposits in Jordan, since part of these deposits, which is kept for emergency purposes, may not be used if the need does not arise.

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(1) For further details of this point, see J. Salah, The Evolution of the Banking System in Jordan, op.cit. P.48

Having discussed the developments in the sources of banks' funds and the composition and nature of their deposits, it is now necessary to assess how successful these banks were in performing their function as mobilisers of the community's funds.

The growth in the volume of the private sector's deposits from JD 29.79 million in 1964 to JD 262.84 million in 1977,[1] and the rise in their relative importance in bank funds from 46.6% to 71.5% during the same period,[2] may suggest that commercial banks achieved a noticeable success in institutionalising domestic savings. However, to precisely assess the mobilisation function of the banks, the following two measures are employed: (a) the growth in bank deposits in relation to GNP, and (b) the expansion in the network of bank branches in relation to the number of inhabitants.

Changes in the ratio of bank deposits to GNP reveals that banks in Jordan achieved notable progress in mobilising funds. The ratio averaged around 26.2%, rising from only 18.5% in 1964 to 38.6% by 1976.[3] This can be favourably compared with the situation in other developing countries included in Table 4.4 during the same period. As demonstrated by the table, the Jordanian ratio behaved in a similar manner to that of Greece where its ratio accounted, on average, for 24.5% whereas the Jordanian ratio was considerably above that of Turkey, Egypt, India, Iraq and Sudan where the same ratio averaged around 21.7%, 21.1%, 15.6%, 10.5% and 9.1% respectively.[4]

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(1) Including private sector's deposits (residents and non-residents) as shown by Table 4.2

(2) See Table 4.1

(3) The analysis here does not include 1977 because figures for this year regarding other countries included in the table have not yet been published.

(4) See Figure 4.2

Table 4.4 Bank Deposits* to GNP Ratio In Selected Developing Countries, 1964 - 1976

%

| Years | Jordan | Greece | Turkey | Egypt | India | Iraq | Sudan |
|---|---|---|---|---|---|---|---|
| 1964 | 18.5 | 17.3 | 15.6 | 20.1 | 11.1 | 9.7 | 6.0 |
| 1965 | 20.9 | 16.4 | 18.6 | 18.1 | 12.1 | 10.5 | 6.7 |
| 1966 | 25.1 | 18.1 | 20.3 | 17.4 | 12.3 | 10.3 | 7.4 |
| 1967 | 20.8 | 18.2 | 25.4 | 19.0 | 11.6 | 10.6 | 8.1 |
| 1968 | 22.7 | 18.7 | 23.8 | 18.9 | 12.8 | 11.1 | 7.4 |
| 1969 | 20.5 | 23.4 | 25.2 | 18.0 | 13.3 | 11.7 | 8.3 |
| 1970 | 20.3 | 26.2 | 21.9 | 17.0 | 13.8 | 10.4 | 9.2 |
| 1971 | 25.5 | 28.4 | 22.2 | 18.3 | 16.0 | 10.5 | 9.3 |
| 1972 | 28.6 | 31.6 | 22.9 | 20.8 | 18.7 | 10.9 | 10.9 |
| 1973 | 31.8 | 27.4 | 22.6 | 26.8 | 18.3 | 11.8 | 11.5 |
| 1974 | 32.3 | 27.6 | 20.5 | 26.6 | 17.8 | 8.5 | 10.9 |
| 1975 | 38.5 | 30.4 | 21.5 | 27.0 | 19.5 | 10.4 | 11.1 |
| 1976 | 38.3 | 31.9 | 21.4 | 26.6 | 23.7 | 10.6 | 12.0 |
| Average Ratio 1964-76 | 26.2 | 24.5 | 21.7 | 21.1 | 15.6 | 10.5 | 9.1 |

Source: (1) IMF, IFS (1972 Supplement)
(2) ___, IFS (Dec. 1977)
(3) ___, IFS (Dec. 1978)

* private sector's deposits.

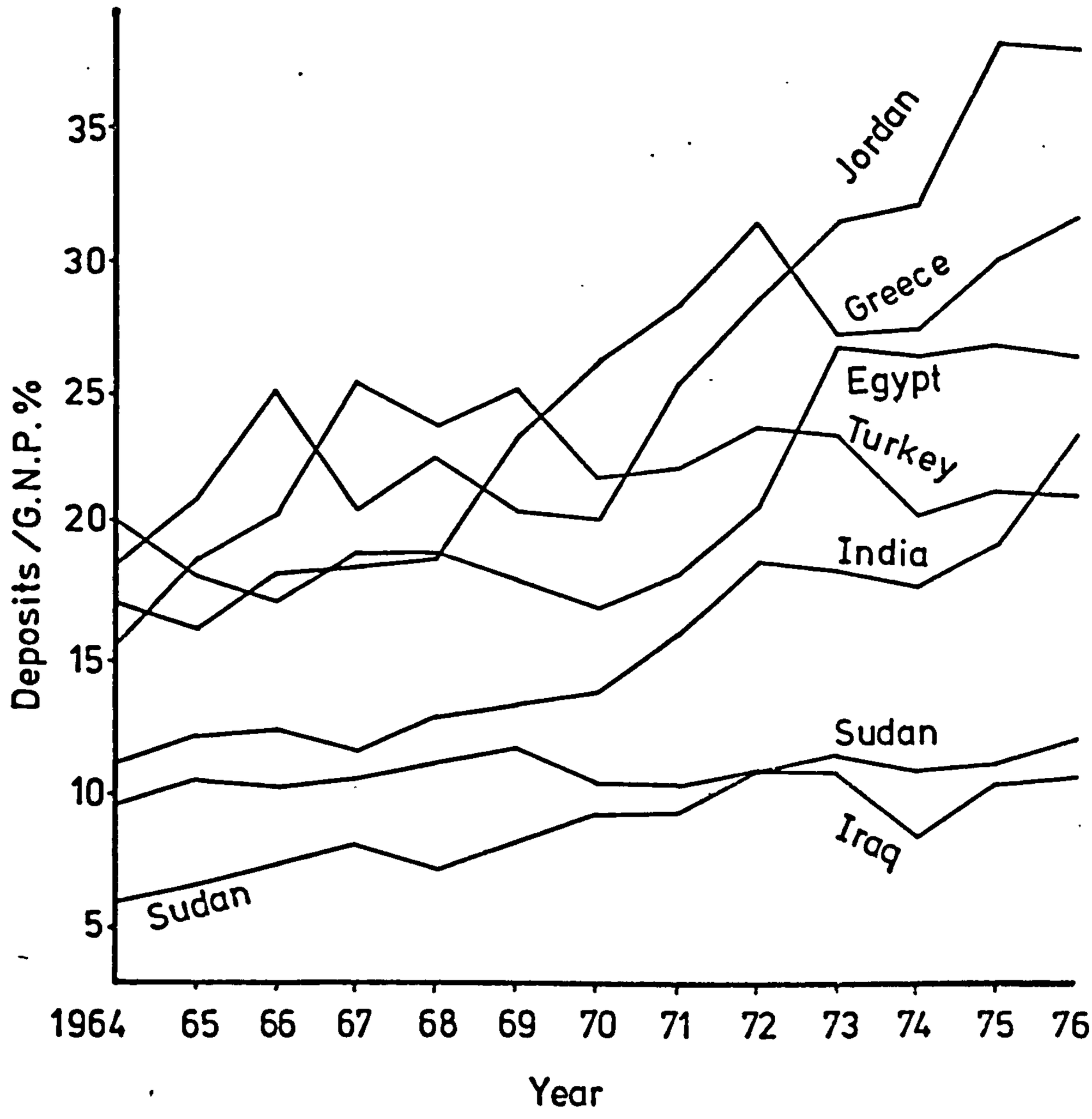


Fig 4 - 2 Bank deposit to G.N.P. ratio in selected developing countries from 1964 to 1976.

( source : table 4 - 4 )

However, such a remarkable rise in the bank deposit/GNP ratio not only reflects banks' concerns and efforts to mobilise funds, but it is also the result of the steady growth of the Jordanian economy which encouraged bank activities. Thus, income factors as well as institutional factors have both stimulated the noticeable increase in the above ratio. On the one hand, internal development has undoubtedly encouraged bank growth through a steady rise in money incomes and the consequent increase in domestic savings. On the other hand, the notable extension of the network of bank branches throughout the country has increasingly enabled commercial banks to institutionalise domestic funds. Prior to 1967, bank branches were increasing steadily in both parts of the country (the East Bank and the West Bank). Thus, by the end of 1967, the number of bank offices increased to 59 as compared with 43 in 1964. As can be seen from Table 4.5, such branches were about equally distributed between the two regions with the relative share of the East Bank being slightly higher (comprising 32 offices or 54% of the total). Expansion in bank branches was greatly disrupted by the Arab-Israeli War of 1967 and the consequent occupation of the West Bank of Jordan. As a result, all bank branches there were closed. The War, and its aftermath, also influenced bank activities in the East Bank of Jordan, as reflected in the slow growth of bank offices in the following two years. Branch expansion was again retarded by the civil war of 1970, which seriously hindered all economic activities. The number of branches in the following year remained constant at 40. It was only when the country experienced a relative degree of political stability in 1973, together with the launching of a new era of planning development in that year, that banks resumed a rapid expansion of their branches. This was also accompanied by the recent entry of new foreign banks into banking business in Jordan,

Table 4.5

## Network of Bank Branches and Bank Density in Jordan 1964 - 1976

| Years | Number of Bank Branches | | | | | | | | | | Population '000s | | | | | | Population per Bank Branch | | | Bank Density Index (Cameron's Method)** | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | East Bank of Jordan | | | | | | West Bank (2) | | Total (3) | | East Bank | | West Bank* | | Total | | East Bank | West Bank | Total | East Bank | West Bank | Total |
| | Amman & Its Suburbs | | Other Areas | | Total (1) | | | | | | | | | | | | | | | | | |
| | Abs. | % of (1) | Abs. | % of (1) | Abs. | % of (3) | Abs. | % of (3) | Abs. | % | Abs. | % | Abs. | % | Abs. | % | | | | | | |
| 1964 | 10 | 43.5 | 13 | 56.5 | 23 | 53.5 | 20 | 46.5 | 43 | 100.0 | 1,254 | 66.7 | 0,626 | 33.3 | 1,880 | 100.0 | 54,522 | 31,300 | 43,721 | 0.183 | 0.319 | 0.229 |
| 1967 | 11 | 34.4 | 21 | 65.6 | 32 | 54.2 | 27 | 45.8 | 59 | 100.0 | 1,360 | 66.7 | 0,680 | 33.3 | 2,040 | 100.0 | 42,500 | 25,185 | 34,576 | 0.235 | 0.397 | 0.289 |
| 1968*** | 11 | 33.3 | 22 | 66.7 | 33 | | | | | | 1,527 | 71.0 | 0,623 | 29.0 | 2,150 | 100.0 | 46,273 | | | 0.216 | | |
| 1969 | 13 | 37.1 | 22 | 62.9 | 35 | | | | | | 1,555 | 71.0 | 0,635 | 29.0 | 2,190 | 100.0 | 44,429 | | | 0.225 | | |
| 1970 | 17 | 42.5 | 23 | 57.5 | 40 | | | | | | 1,633 | 71.0 | 0,667 | 29.0 | 2,300 | 100.0 | 40,825 | | | 0.245 | | |
| 1971 | 17 | 42.5 | 23 | 57.5 | 40 | | | | | | 1,690 | 71.0 | 0,690 | 29.0 | 2,380 | 100.0 | 42,250 | | | 0.237 | | |
| 1972 | 20 | 45.5 | 24 | 54.5 | 44 | | | | | | 1,747 | 71.0 | 0,713 | 29.0 | 2,460 | 100.0 | 39,705 | | | 0.252 | | |
| 1973 | 25 | 45.5 | 30 | 54.5 | 55 | | | | | | 1,803 | 71.0 | 0,737 | 29.0 | 2,540 | 100.0 | 32,782 | | | 0.305 | | |
| 1974 | 38 | 52.8 | 34 | 47.2 | 72 | | | | | | 1,860 | 71.0 | 0,760 | 29.0 | 2,620 | 100.0 | 25,833 | | | 0.387 | | |
| 1975 | 42 | 54.5 | 35 | 45.5 | 77 | | | | | | 1,956 | 71.0 | 0,800 | 29.0 | 2,756 | 100.0 | 25,403 | | | 0.394 | | |
| 1976 | n.a. | n.a. | n.a. | n.a. | 81 | | | | | | 1,973 | 71.0 | 0,807 | 29.0 | 2,780 | 100.0 | 24,358 | | | 0.410 | | |

Source: (1) For bank branches, see Appendix 4.3

(2) For Population Figures, IMF., IFS., 1971 Supplement; and Jordan Dept. of Statistics, Statistical Year Book 1971, (Amman: Dept of Statistics Press) No.22.

* The population of the West Bank of Jordan before 1967 accounted for one third of the total population of the Kingdom. (See: H. Odeh, Economic Development of Jordan, 1954-71 (Amman: Jordanian Press Foundation, 1972) P.37. The relative distribution of population between the two banks has been altered after the 1967 War and the subsequent influx of 400,000 to the East Bank. According to the Jordan Dept. of Statistics, the new relative distribution became 29%, 71% in both the West and East Banks respectively. (See: Jordan Dept. of Statistics, Statistical Year Book, 1971) Table 1, P.2

** $\frac{\text{No. of bank offices} \times 10,000}{\text{Total Population}}$

*** Figures from 1968 onwards include only the East Bank of Jordan because of the closure of Bank Branches in the West Bank as a result of the 1967 War.

starting with the local establishment of the First National City Bank in 1974 and followed, in 1975, by the Chase Manhattan Bank and the Bank of Credit and Commerce International. As a result, bank branches in the East Bank rose to 81 by 1976, compared with a mere 23 in 1964. Such institutional expansion increased the number of inhabitants having access to bank facilities. Thus, in terms of domestic bank facilities per head of population, there was one banking office in the East Bank per 24,358 in 1976, as compared with the 1964 figure of one per 54,522 inhabitants. In other words, these figures meant that in 1976, there were two bank branches serving about the same population as used to be covered by one bank office in 1964.

However, it is worth noting that although the increase in bank branches was substantial, most of the expansion was confined to Amman and the other main cities, thereby leaving a large number of small towns and villages without adequate bank facilities. For example, 10 out of the 23 bank offices in the East Bank in 1964 were situated in Amman and its suburbs (i.e. 43.5%). The table shows that the concentration of bank branches in Amman was further increased in recent years, when its relative share accounted for 54.5% by 1975. This concentration can be, generally,explained by the dominant position of Amman as a prosperous commercial and industrial centre, and partly by the traditional practice of some commercial banks, particularly the foreign banks, of confining their activities to the big cities and commercial centres . Such a situation not only prevents people living in rural areas from the benefits of using bank facilities, but also deprives the economy itself of the proper use of its resources, since part of the funds available in the remote areas are kept in idle forms which could otherwise be mobilised in financial assets.

Although banks achieved notable progress in institutionalising funds, as indicated by the increasing proportions of population covered by bank services, banking density in Jordan is still low as measured by Cameron's universal method. Based on his observations of banking development in many countries during different stages of development, Rondo Cameron developed the banking density concept as a crude index of financial development. Although the application of this method should be treated with some reservation, it nevertheless can be employed as an approximate measure for the adequacy of bank branches in relation to total population. The above term refers to the number of bank branches per 10,000 population. From his experience, Cameron classified a banking density ratio of over 1.0 as 'high' (i.e. one bank office for 10,000 person ); between 0.5 and 1.0 as 'moderate'; and below 0.5 as 'low'; and finally, below 0.1 as 'very low'.(1) When applying Cameron's method to the Jordanian case, Jordan can be classified as having a low bank density, despite the rapid expansion in the network of branches of recent years. This ratio, however, increased steadily during the whole period, as can be seen from Figure 4.3, rising from only 0.183 in 1964 (being very near to the 'very low' level) to 0.410 in 1976.(2) These figures reveal that although, on Cameron's scale, banks in Jordan still had a low density ratio, they on the other hand displayed increasing efforts to serve larger proportions of population.

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(1) R. Cameron & others, Banking in the Early Stages of Industrialisation, op.cit. P. 297

(2) The Jordanian banking density ratio in 1976 was slightly above the Japanese ratio in 1884 (0.320) and the Prussian ratio in 1861 (0.340), whereas it was slightly lower than that of England and Wales in 1800 (0.480). See Ibid. PP. 297 - 298

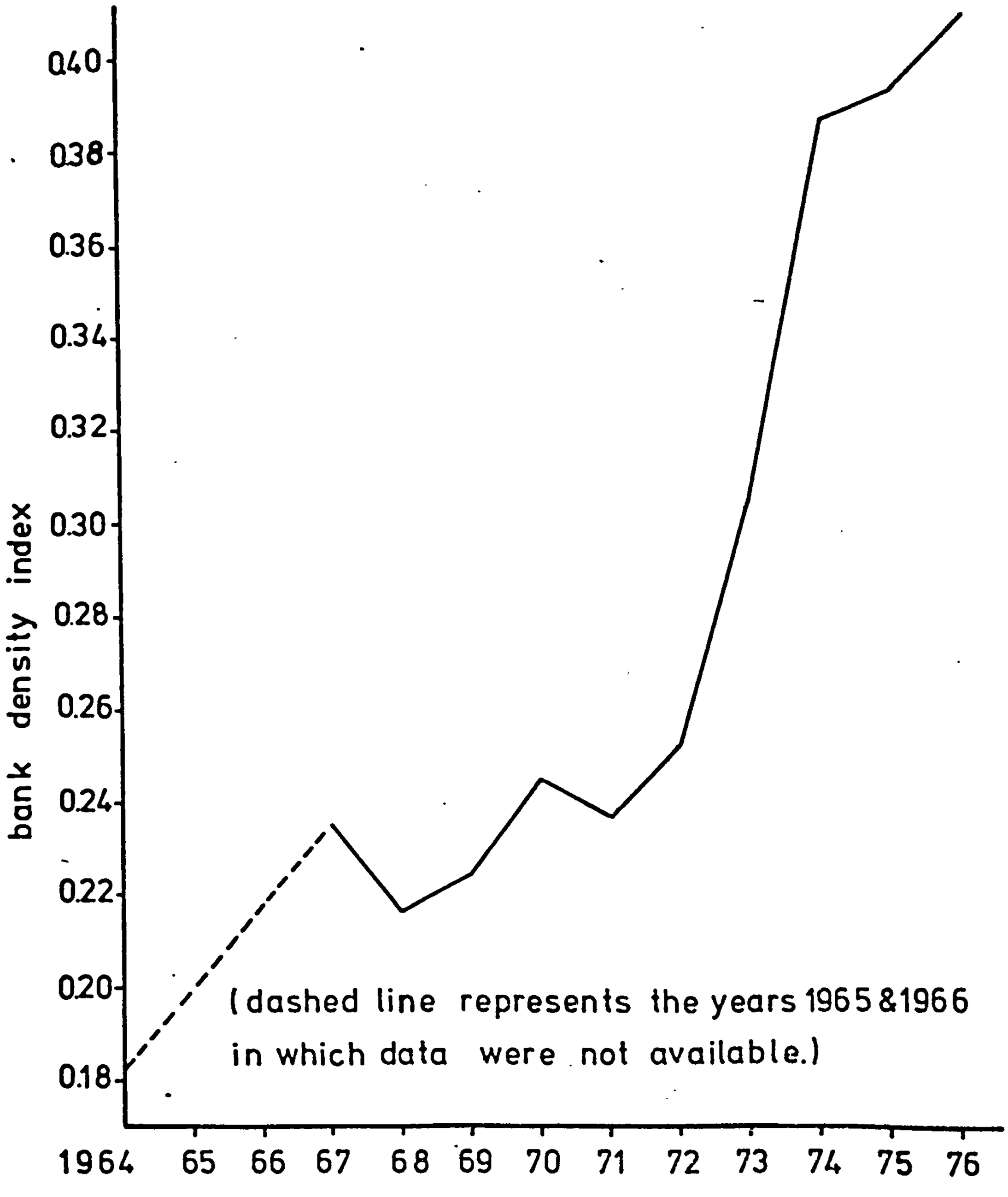


Fig. 4-3 Bank density index in Jordan from 1964 to 1976

( source : table 4-5 )

Finally, it should be mentioned that banks in Jordan did not adopt sufficiently active policies to encourage people to utilise banks as reservoirs of their funds, especially in the rural areas, where a large proportion of people are still not fully aware of the benefits and facilities offered by banks. Furthermore, commercial banks did not offer attractive rates of return on holding bank deposits, which would have encouraged people to pour more of their funds into the banking system. As will be discussed in detail in Chapter 11, commercial banks were unable to offer the public attractive yields on their financial holdings because of the maintenance of a low and conventional interest rate policy by the monetary authorities.

## II

## Uses of Bank Funds

The allocative function of commercial banks has an important bearing on, and considerable implications for, a country's rate of economic development. Bank portfolio behaviour and the way these banks distribute their funds between domestic and foreign outlets, on the one hand, and the composition of their domestic investment on the other, may significantly influence the allocation of capital among various sectors of the economy. Clearly, the more resources allocated in sectors of national priority, the larger the contribution of commercial banks to domestic economic development. It is by this allocative function that such institutions can substantially assist the developmental process by adjusting their asset structure in accordance with the defined development strategies.

An examination of Table 4.6 reveals that asset portfolio behaviour of the commercial banks in Jordan has undergone significant changes in favour of domestic assets during the period 1964 - 1977, their relative importance in total assets rising from 60.2% to 90.0%. This favourable

Table 4.6

## Uses of Bank Funds, 1964 - 1977

(In millions JD)

| Years | Domestic Uses | | | | | | | | | | | | | | | | | | | | Foreign Uses | | | | | | Total Bank Assets | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Loans and Advances | | | | | | Liquid Assets | | | | | | | | Investment in Private Shares & Securities (3) | | Other Assets (4) | | Total Domestic Uses (1-4) | | Balances with Banks Abroad (5) | | Foreign Securities (6) | | Total (5+6) | | | |
| | Overdrafts & Advances | | Bill's Discounted | | Total (1) | | Cash & Balances with Local Banks | | Balances with the CBJ | | Treasury Bills & Govt. Bonds | | Total (2) | | | | | | | | | | | | | | | |
| | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % |
| 1964 | 20.73 | 32.4 | 8.54 | 13.4 | 29.27 | 45.8 | 4.88 | 7.7 | 0.35 | 0.5 | - | - | 5.23 | 8.2 | 0.23 | 0.4 | 3.76 | 5.8 | 38.48 | 60.2 | 25.25 | 39.4 | 0.23 | 0.4 | 25.48 | 39.8 | 63.96 | 100.0 |
| 1965 | 24.05 | 40.1 | 9.25 | 15.4 | 33.30 | 55.5 | 2.84 | 4.7 | 7.80 | 13.0 | - | - | 10.64 | 17.7 | 0.41 | 0.7 | 5.60 | 9.4 | 49.96 | 83.3 | 9.81 | 16.3 | 0.24 | 0.4 | 10.05 | 16.7 | 60.01 | 100.0 |
| 1966 | 23.13 | 41.5 | 9.85 | 14.0 | 38.98 | 55.5 | 2.17 | 3.1 | 13.28 | 18.9 | - | - | 15.45 | 22.0 | 0.79 | 1.1 | 7.79 | 11.1 | 63.00 | 89.7 | 7.22 | 10.3 | 0.04 | - | 7.26 | 10.3 | 70.26 | 100.0 |
| 1967 | 30.57 | 43.2 | 8.32 | 11.7 | 38.89 | 54.9 | 2.29 | 3.2 | 16.94 | 23.9 | - | - | 19.23 | 27.1 | 0.91 | 1.3 | 6.48 | 20.3 | 65.50 | 92.5 | 5.25 | 7.5 | 0.06 | - | 5.31 | 7.5 | 70.81 | 100.0 |
| 1968 | 32.97 | 46.3 | 8.03 | 11.3 | 41.00 | 57.6 | 2.65 | 3.7 | 15.69 | 22.0 | - | - | 18.34 | 25.7 | 1.01 | 1.4 | 4.61 | 6.4 | 64.94 | 91.1 | 6.23 | 8.9 | 0.04 | - | 6.32 | 8.9 | 71.26 | 100.0 |
| 1969 | 36.50 | 48.8 | 8.89 | 11.9 | 45.39 | 60.7 | 2.33 | 3.0 | 12.58 | 16.8 | 3.77 | 5.0 | 18.68 | 25.0 | 1.02 | 1.4 | 4.81 | 6.4 | 69.90 | 93.5 | 4.80 | 6.5 | 0.02 | - | 4.82 | 6.5 | 74.72 | 100.0 |
| 1970 | 37.58 | 49.2 | 7.96 | 10.4 | 45.54 | 59.6 | 2.29 | 3.0 | 12.86 | 16.8 | 3.34 | 4.4 | 18.49 | 24.2 | 0.89 | 1.3 | 5.40 | 7.0 | 70.53 | 92.1 | 5.48 | 7.2 | 0.59 | 0.7 | 6.07 | 7.9 | 76.40 | 100.0 |
| 1971 | 38.80 | 47.2 | 8.12 | 9.9 | 46.92 | 57.1 | 1.85 | 2.2 | 14.86 | 18.1 | 8.55 | 10.4 | 25.26 | 30.7 | 0.89 | 1.1 | 6.05 | 7.4 | 79.12 | 96.3 | 2.35 | 2.8 | 0.73 | 0.9 | 3.08 | 3.7 | 82.20 | 100.0 |
| 1972 | 40.22 | 42.1 | 10.38 | 10.9 | 50.60 | 53 0 | 2.16 | 2.3 | 17.27 | 18.1 | 16.18 | 16.9 | 35.61 | 37.3 | 0.91 | 0.9 | 5.08 | 5.3 | 92.15 | 96.5 | 2.66 | 2.8 | 0.72 | 0.7 | 3.38 | 3.5 | 95.53 | 100.0 |
| 1973 | 49.04 | 43.9 | 12.78 | 11.5 | 61.82 | 55.4 | 2.39 | 2.1 | 16.76 | 15.0 | 16.94 | 15.2 | 36.09 | 32.3 | 1.17 | 1.0 | 5.97 | 5.4 | 105.05 | 94.1 | 5.78 | 5.2 | 0.77 | 0.7 | 6.55 | 5.9 | 111.60 | 100.0 |
| 1974 | 67.27 | 47.0 | 16.71 | 11.6 | 83.98 | 58.6 | 3.80 | 2.7 | 21.97 | 15.3 | 14.88 | 10.4 | 40.65 | 28.4 | 1.35 | 0.9 | 9.32 | 6.5 | 135.29 | 94.4 | 7.05 | 4.9 | 0.91 | 0.7 | 7.96 | 5.6 | 143.25 | 100.0 |
| 1975 | 98.66 | 46.3 | 22.77 | 10.7 | 121.43 | 57.0 | 6.69 | 3.1 | 32.91 | 15.4 | 24.48 | 11.5 | 64.08 | 30.0 | 1.37 | 0.6 | 13.97 | 6.6 | 200.75 | 94.2 | 11.26 | 5.2 | 1.19 | 0.6 | 12.45 | 5.8 | 213.20 | 100.0 |
| 1976 | 147.46 | 48.9 | 36.28 | 12.0 | 183.74 | 60.9 | 6.78 | 2.2 | 50.60 | 16.8 | 21.61 | 7.2 | 78.99 | 26.2 | 1.60 | 0.5 | 17.93 | 6.0 | 282.27 | 93.6 | 17.65 | 5.9 | 1.58 | 0.5 | 19.23 | 6.4 | 301.50 | 100.0 |
| 1977 | 157.59 | 42.9 | 43.51 | 11.8 | 201.10 | 54.7 | 14.25 | 3.9 | 62.87 | 17.1 | 32.85 | 8.9 | 109.97 | 29.9 | 2.50 | 0.7 | 17.09 | 4.7 | 330.66 | 90.0 | 34.95 | 9.5 | 1.78 | 0.5 | 36.73 | 10.0 | 367.39 | 100.0 |
| [illegible]-77 | | 44.3 | | 11.9 | | 56.2 | | 3.3 | | 16.3 | | 6.4 | | 26.0 | | 0.9 | | 7.7 | | 90.8 | | 8.8 | | 0.4 | | 9.2 | | 100.0 |

Source: (1) Central Bank of Jordan, The Annual Report, (1966, 1971)

(2) _____, Monthly Statistical Bulletin (June 1977; Dec. 1978)

shift towards domestic investment was related, on the one hand, to legislative prohibition of overseas investment, and, on the other, to a rapid internal development. Under the Currency Board System (1951 - 1963), banks in Jordan were completely free to invest in foreign assets which accounted, on average, for 90.3% of bank liquid assets throughout the whole period.(1) This situation was completely changed under the Central Banking Regime when such a traditional practice was made illegal.(2) The aim was to repatriate overseas funds transferred abroad through bank operations and to ensure that they would be internally invested. As can be seen from the table, the relative share of overseas investment in total bank assets declined noticeably from 39.8% in 1964 to 16.7% in 1965 and to 10.3% in 1966. This percentage continued to decline up to 1972 when it reached only 3.5%. From 1973 onwards, however, the relative importance of foreign assets rose slightly to reach 5.9% in 1973 and 10.0% by 1977. This increase was owing to the CBJ's decision of allowing commercial banks to accept deposits in foreign currencies from Jordanians working abroad and non-residents. As it was observed earlier,(3) this procedure led to a slight increase in bank overseas liabilities. Banks therefore found it appropriate to hold more foreign assets in their portfolio to cover the increase in their liabilities abroad.

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(1) Jamal Salah, The Evolution of the Banking System in Jordan, op.cit. P.40

(2) Article 11 of the Temporary Banking Law of 1966 made it clear that commercial banks became no longer allowed to invest abroad. Banks' holdings of foreign assets were restricted to levels just sufficient to cover their overseas liabilities. See: Temporary Banking Law No. 94, 1966, Article 11-H P. 17 (In Arabic)

(3) See P. 93

Loans and Advances. The same table shows that, out of the domestic use, credit facilities represented the largest item in the assets side, claiming an average of more than half of the total during the whole period. Such credit was mainly extended in the form of overdraft which comprised, on average, 44.3% of bank assets during the same period. This credit continued to be largely concentrated in the traditional foreign trade sector. Still influenced by the orthodox commercial loan theory, commercial banks in Jordan, modelled on the British, maintained their past experience of providing loans for only short-term purposes. Proper term lending was virtually non-existent. As will be discussed later in this chapter, credit concentration in financing the foreign trade sector and term lending practice have both significant implications for the economic development of the Country.

Liquid Assets. Bank holdings of domestic liquid assets claimed, on average, about one quarter of total bank assets during the period under review. Their relative share experienced significant changes over the years, rising from only 8.2% in 1964 to 29.9% by 1977. This noticeable shift can be explained by two main factors: (a) as a result of repatriating overseas funds, the CBJ had to provide alternative domestic avenues for banks' liquid investments. These banks were allowed to deposit their funds with the CBJ against receiving interest.(1) This procedure led to a rise in the relative share of liquid assets from only 8.2% of total assets in 1964 to 17.7% and 22.0% in 1965 and 1966 respectively. (b) The introduction of new forms of domestic liquid assets (representing

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(1) This point is discussed later in the Chapter. See P. 142

treasury bills in 1969 and development bonds in 1971[1]) further increased the relative significance of liquid assets in bank asset portfolio. Although commercial banks financed their purchase of treasury bills in 1969 by running down their balances with the CBJ (i.e. by changing the relative composition of the liquid assets themselves), the purchase of government bonds in 1971 was mainly financed by running down their holdings of foreign assets, which declined from 7.9% of total assets in 1970 to 3.7% in 1971. As can be seen from the table, the acquisition of treasury bills in 1969 did not result in any change in the relative share of liquid assets, whereas the purchase of development bonds in 1971 increased the relative importance of liquid assets to 30.7% as compared with 24.2% in 1970.

However, although the structure of bank liquid assets has changed in favour of domestic uses, the volume of liquid assets held by the banks in relation to their deposits has still been high and above the officially desired level. It will be argued later that the excess liquidity maintained by banks has an important bearing as a potential source of financing economic development.

Equity Investment. Bank holdings of industrial shares and securities comprised only a minor proportion of their total assets, averaging less than 1% throughout the whole period. This indicated the insignificant participation of commercial banks in the equity capital of the industrial enterprises, thus reflecting banks' conservative attitude towards this type of investment. Their conservatism can be further illustrated if the value of their share holdings is compared with the legal ceilings

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(1) Although these bonds had a maturity of three years, they were considered by the CBJ as liquid assets for purposes of computing liquidity ratios. This procedure was taken to encourage banks to acquire these bonds in their asset portfolio. See the CBJ, Eigth Annual Report, 1971, P.70

that commercial banks were forbidden to overtake in equity participation. Bank investment in the equity capital of any industrial, commercial and agricultural enterprise was restricted by law to a certain percentage of the bank total capital and reserves. The maximum ceiling was fixed in the 1959 Law at 15%, then raised to 25% and finally to 75% in accordance with the two amending laws of 1966 and 1971.(1) Despite these relaxations, however, equity participation continued to form only a minor segment of bank capital and reserves. As indicated by the table, such investments reached a maximum of JD 2.50 million in 1977, thus comprising only 12% of total bank capital and reserves.

Not only did commercial banks shy away from any significant participation in the equity capital of the industrial firms, but these banks also hesitated to furnish these industries with the type of credit necessary to finance their expansion. It will be shown that even the small proportion of their credit going to finance industrial activities was confined only to financing the circulating capital of existing industries. Commercial banks never ventured beyond their traditional boundaries by extending their operations to finance medium or long-term financial requirements of industrialists. Moreover, they have not maintained close relations with the industrial sector in the sense of providing financial advice and assistance in the preparation of new industrial undertakings, unlike the experience of many countries during their early stages of development.(2) It can be,therefore, said that

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(1) Excluded from this restriction was the participation in the equity capital of any project or institution with a direct relation to economic development.

(2) Germany and Japan have been cited as cases in point. See Chapter 1, PP. 2-3

commercial banks in Jordan played little direct role in promoting industrial development. It was for this reason that the need arose for a specialised financial institution capable of meeting such industrial requirements. As will be discussed in Chapter 8, these needs were partly met by the Industrial Development Bank which was established in 1965.

However, in the context of the promotional impact of the commercial banks, indirect contribution was made by these banks to industrial expansion by their provision of share transaction facilities. Since a domestic capital market only commenced operations in 1978, industrial firms used to raise funds through the commercial banks. This undoubtedly made it more convenient for industrialists to meet their financial needs, and, at the same time, encouraged the public to invest in industrial enterprises. Purchase through the banking system had in fact more response from the public than would have been the case if people had to buy direct from the firms. Influenced by their confidence in the banking system, people believed that commercial banks would not accept such undertaking unless they themselves were convinced of the future financial position of these firms.

Having analysed the composition of bank assets and the channels in which resources have been invested, it is necessary now to assess the allocation function of commercial banks; showing how far their asset portfolio behaviour has been in line with the country's development needs. Thus, from an economic development point of view, three areas of functional deficiencies can be recognised: firstly, strict adherence to traditional banking practice of confining bank credit only to short-term loans; term lending was virtually non-existent. Secondly, a distinct sectoral bias towards financing foreign trade transactions; little attention has been given to priority sectors. Thirdly, maintaining excessive liquidity in domestic banking, which has been unnecessarily held because of conservatism and lack of innovation on the part of many

banks. These systemic features will now be examined in detail.

(a) A Strict adherence to 'traditional' commercial banking theory.

Influenced by their past, commercial banks in Jordan followed the British banking tradition of confining credit extended to short-term loans. This traditional practice is based on the ground that banks should not lock up in illiquid medium and long-term advances funds which they have acquired on sight or short notice. Such an orthodox banking practice of borrowing short and lending short is undoubtedly sound and characterised the successful experience of British banks over their long history. This concept formed the base for the 'commercial loan theory' of banking which predominated in the 1920's. However, a departure from this theory took place in the U.S.A. as early as 1933, when the experience of the great depression taught the lesson that the short-term character of a loan was not necessarily an assurance of liquidity for a bank.(1) The departure from orthodoxy was, in fact, necessitated by the growing demands made upon the commercial banks for longer-term credit. After the great depression of 1933, many industrial firms in the U.S.A. experienced an increasing demand for longer-term advances.(2) In response to this, commercial banks began to review their operational criteria and then deviated from orthodoxy by introducing the term-lending technique into their practice.(3)

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(1) The American Bankers Association, The Commercial Banking Industry, (Englewood Cliffs, N.J. Prentic-Hall, inc. 1962) P.148

(2) National Bureau of Economic Research, Capital in Manufacturing and Mining, Its Formation and Financing (Princeton: Princeton University Press, 1960) P.179.

(3) The expression 'term lending' refers to loans with maturities over one year (i.e. both medium and long-term loans). Term lending is used in the discussion as distinct from short-term lending which is usually extended for periods up to one year.

However, the above innovation was not only necessitated by changing economic needs, but it was also justified on theoretical grounds. Banks' considerations and attitudes towards their liquidity have undergone significant changes over time, and have become nowadays less connected to the short-term character and self-liquidating aspect of the commercial loan theory. Attitudes and views on how a bank can best provide for its liquidity have changed over the last 50 years, from the traditional concept of the 'commercial loan theory' of the 1920's, to the 'shiftability thesis' in the 1930's, to the theory of 'anticipated income' in the 1940's and 1950's and, finally, to the doctrine of 'liability management' in the 1960's.(1) These theories have largely influenced banking practice in many countries, while they only left marginal impacts on others. It is therefore necessary, first of all, to briefly review the above four theories which provided the theoretical base on which commercial banks relied in undertaking longer-term business.(2)

(1) The 'Commercial Loan Theory' of Banking. This theory insists that because of the nature of their deposits, commercial banks should confine their business to short-term, self-liquidating transactions.(3)

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(1) L. Ritter and W. Silber, Principles of Money, Banking and Financial Markets, (New York: Basic Books, Inc., Publishers, 1974) P.399.

(2) Throughout the discussion of banking theories, reference is made to the following: Ritler and Silber, op.cit. PP.400-405; and the American Bankers Association, op.cit. PP.146-153; and S. Basu, A Review of Current Banking and Practice (London: Macmillan Ltd. 1974) PP.261-266.

(3) The 'Self-liquidating' aspect of the theory implies that the funds which the borrower must use to repay his loan should arise from the very transaction being financed by the same loan. Financing inventories can serve as illustrating examples here since the borrower is expected to repay his loan from the quick sale of these inventories. Such transactions being on short-terms and of self-liquidating character would give a continuous and automatic self-liquidation of bank assets. See Ritter and Silber, op.cit.P.400

As was shown earlier, the experience of the 1933 depression proved the fallacy of this theory because banks' attempts to obtain payments of such loans to meet deposits' withdrawals often failed. This experience showed that the short-term and self-liquidating character of loans was not a guarantee for bank liquidity.

(2) The 'Shiftability Thesis' . The shortcomings of the above theory led to the development of the shiftability thesis which means that the bank can safeguard its liquidity if it possesses assets, regardless of their nature, which can be sold readily when funds are needed. This theory, however, had a similar defect to the preceding traditional theory, since securing liquidity by shifting assets to others is not guaranteed in a crisis, when all banks are affected and when an individual bank faces difficulties in shifting its own assets to obtain liquidity. In such circumstances, liquidity is obtained from the Central Bank which is the ultimate source of liquidity for the banking system as a whole. Within this concept, the extent of an individual bank liquidity, instead of depending on the short-term,self-liquidating aspect of an asset, became more related to the ability of the bank to shift assets, especially to the Central Bank, and the extent to which the latter accepts such shiftable assets.

(3) The'Anticipated Income' Theory. The shiftability thesis encouraged commercial banks to extend their operations into holding longer-term assets as far as these assets are sound, and especially if they are easily shiftable and acceptable to the Central Bank. Started in the U.S.A., as indicated earlier, commercial banks developed the term-lending technique by providing medium and long-term credit to businessmen. This was based on a new theory called the anticipated income which was a distinct departure from the traditional loan theory. A term loan, having a maturity of more than a year but usually not exceeding five years, is repayable either by regular instalments over a fixed period of time, or in full at a given date. The repayments are

usually made out of the future earnings of the borrower which accrue to him from his transactions with numerous third parties. This is in sharp contrast with the self-liquidating aspect of the commercial loan theory which claimed that every loan should automatically generate its own repayments. What is important according to the new theory is the soundness of the loan and the proper examination of the borrower's creditworthiness. This theory has changed banks' attitudes and considerations for their liquidity: while in the traditional loan theory loans are liquidated by selling the borrower's assets, and in the shiftability doctrine by shifting them to other parties, bank liquidity according to the anticipated income concept can be provided by periodical repayments which provide a continuous cash inflow, thus contributing regularly to liquidity. Bank liquidity, moreover, can be provided by resorting to the Central Bank in an emergency.

(4) Liability Management. A new development in liquidity considerations occurred in the 1960's when the interest was shifted to the other part of the balance sheet, i.e. the liabilities side. With the exception of the occasional resort to the Central Bank, the aforementioned three theories relied on asset management for providing liquidity; whereas the fourth concept reveals that banks can secure their liquidity by managing their liabilities. That is, instead of adapting their assets portfolio to fit the structure of their liabilities, banks began to take a target asset growth as given and then adjust their liabilities to meet their needs. Banks, therefore, started to invest their funds in different types of assets, regardless of their liquidity, relying on their ability to borrow money when the need for liquidity arose. One main defect of this theory, however, is that bank liquidity in this case will depend mainly on market conditions which may not be encouraging for borrowing. Competition with other borrowing instruments, such as

treasury bills, together with the intervention of the Central Bank in the market operations, may sometimes make it unprofitable for banks to borrow, thus endangering their liquidity.

What can be understood from the above theories is that banks' considerations for their liquidity have undergone considerable changes over time and, in actual practice nowadays, they depend on managing both sides of their balance sheet to secure liquidity. Moreover, the recent theories proved the fallacy of the strict adherence to the commercial loan theory, thus providing a solid theoretical base for term lending practice. This was further encouraged by some views expressed by bankers and economists who strongly criticised the traditional loan theory. For example, in a lecture given at the 6th International Banking Summer School in 1953, Dr. Shweitzer emphasised the fact that bank credit has nowadays lost, to a great extent, its self-liquidating and self-securing character as implied by the orthodox banking theory.(1) The fallacy of this theory was earlier shown by Joseph Schumpeter when he stated that:

> " The short-term character of bank credit is indeed one of the fictions of banking theory and rests on the prejudice that banks essentially lend their depositors' money whereas their essential function lies in their creation of money, not in acting as intermediaries between borrowers and depositors."(2)

On the practical side, term lending continued to form increasing proportions of the American's bank credit, rising from one quarter in 1939 to 38% in 1957.(3) The relative importance of this type of credit was further increased to average around 53% - 58% between 1960 - 1963.(4)

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(1) Dr. S. Schweitzer, "The Transformation of Bank Credit and Its New Forms", In Recent Evolution of the Role of Banks in the Economy, Lectures given at the 6th International Banking Summer School in 1953 (Brussels, Association Beige de Banques) P.79.

(2) Joseph A. Schumpeter, "Money and the Social Product", In International Economic Papers (London: Macmillan and Company Ltd. 1956) No. 6, P.204.

(3) The American Bankers Association, Commercial Banking Industry, op.cit. P.146

(4) Joachim Ahrensdorf, "Japanese Bank Loans For Private Fixed Investment", IMF Staff Papers, (March 1965) P.67.

The American experience in this field was followed by many developed countries which found the technique necessary to satisfy the increasing demand for longer-term credit. Germany, Japan, France, and Italy are cases in point where the relative importance of term lending in total credit during the period 1960 - 1963 accounted for 20%, 15%, 14% and 10% respectively.[1] Even in Britain, the origin of banking tradition, there was a shifting interest towards term lending. The Radcliffe Committee in 1959 revealed that such types of credit became no longer alien to British banks and recommended that:

> "The banks should be ready to offer term loans facilities, within reasonable limits, having due regard to their liquidity requirements, as an alternative to running overdraft for creditworthy industrial and commercial customers" (2)

In response to this recommendation, the clearing banks became increasingly engaged in lending for periods up to 5 - 7 years. The involvement of British banks in term lending manifested itself clearly in the 1970's as a result of the ending of quantitative credit restrictions in 1971 and the greater degree of operational flexibility obtained through access to wholesale deposits.[3] Thus by the end of 1976, the proportion of lending provided on a medium-term basis comprised 40% of total credit extended to industry and trade, compared to less than 27% in 1973.[4]

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(1) Ibid

(2) Committee on the Working of the Monetary System "Report Presented to Parliament by the Chancellor of the Exchequer by Command of Her Majesty", Cmnd. 827 (London: August 1959) Paragraph 942.

(3) Committee to Review the Functioning of Financial Institutions: Evidence on the Financing of Industry and Trade (London: H.M.S.O. March 1978) Vol. 5, P.148

(4) Ibid. P.149

The term lending technique also found a strong response in developing countries which realised its significance for the genuine requirements of their economies. This was based on the official recognition of the desperate need of their economies for medium and long-term credit associated with undertaking comprehensive development programmes. Term lending can be used to finance future productive expansion by financing the acquisition of raw materials, livestock, and other industrial machinery and equipment. The importance of term lending was not only emphasised by the monetary authorities in some developing countries, but it was also felt by the commercial banks themselves in countries like India where:

> "The need for participation by commercial banks in equipment capital financing through the provision of term loans in the context of India's rapidly developing economy has been stressed by the country's central bank and also recognised by the bankers themselves. In recent years, the Indian banking system has shown a heightened awareness of this need and has displayed an increasing interest in term-lending business." (1)

The term lending technique was also recommended to Latin American economies. In discussing the role which financial institutions should play in the course of economic development, what Dr. Marquez insisted upon was that the loans should be sound, expressing the view that:

> "There was no reason why commercial banks should not make medium and long-term loans. The liquidity of short-term inventory loans was economically meaningless. Embarrassment of the banks as a result of a shrinkage in the total volume of deposits was not to be expected nowadays since such shrinkage was unlikely. The Central Bank, moreover, could always help them out if necessary".(2)

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(1) S. Basu, A Review of Current Banking and Practice, op.cit. P.283

(2) H. Ellis, Economic Development for Latin America (London: Macmillan and Company Ltd., 1961) P.199

Many developing countries went even further by requiring commercial banks, by law, to extend a certain percentage of their resources for longer-term purposes. Thus, one outstanding feature of bank legislation in these countries is the explicit specification of a certain percentage of banks' funds that should be invested in medium and long-term forms.(1) Bank legislation in Guatemala requires commercial banks to extend a limited amount of loans with maturities in excess of one year but not exceeding three years.(2) The Monetary Board is authorised to specify from time to time the amount of such credit as a percentage, either of bank deposits, or of its capital and reserves.(3) Bank legislation in the Dominican Republic permitted commercial banks to allocate a specified percentage of their funds in loans even for a period exceeding three years subject to the approval of the Superintendent of banks.(4) The Korean General Bank Act also permits commercial banks to extend their activities into long-term business.(5) In Greece, the Central Bank in 1957 required commercial banks to allocate 10% (raised later to 15%) of their deposits for medium and long-term loans, mainly to industrial firms.(6) The General Banking Legislation of Paraguay also allowed commercial banks to extend term loans up to 70% of their saving deposits and of 15% of other deposits.(7)

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(1) S. Basu, A Review of Current Banking and Practice, op.cit. P.281

(2) Ibid.

(3) Ibid.

(4) Ibid.

(5) Ibid.

(6) Xenophon Zolotas, Monetary Equilibrium and Economic Development, with special Reference to the Experience of Greece, 1950 - 1963, (Princeton: Princeton University Press, 1965) P.93.

(7) S. Basu, op.cit. P.281

The above enforcement of term lending in bank legislation in many developing countries reflects the awareness of the authorities of the significance of this type of credit to their economies. However, the significance of term lending differs from one country to another, depending on the prevailing economic and financial circumstances in each individual country. This means that introducing such a technique into banking practice of a country may be unnecessary if the need for this did not arise. As was shown, the business of term lending was a post-war financial innovation introduced by the American banks in response to changing economic needs. Slavish imitation by today's developing countries of the financial experience of the more developed countries, regardless of the special needs of their economies, should be vigourously avoided. Such imitation may be as harmful to these economies as that which would result from their strict adherence to inappropriate orthodox banking practice. In other words, every individual country must adjust its own banking practice to suit its particular environment, guided to a large extent by the hard core financial experience of other countries. Bearing this in mind, it is necessary now to inquire whether there is a case for commercial banks in Jordan to undertake term lending, or whether they are justified in confining their credit to short-term character as understood by orthodox banking practice.

Banks' strict adherence to traditional lending practice might be appropriate to the circumstances within which these institutions used to function during the colonial era. Before independence, no emphasis was given to develop internal agricultural and industrial activities which, by nature, require longer-term facilities. The main interest was directed towards facilitating foreign trade transactions, which usually demand short-term credit. The commercial loan theory, therefore, adequately fit the particular environment within which banks had to operate. These circumstances naturally changed after independence with more emphasis being put on domestic development. Banks nevertheless

continued to extend credit only on a short-term basis, even when the country embarked upon comprehensive development programmes starting in 1973. Strict adherence to orthodox lending practice is undoubtedly harmful since economic development, which involves building up of capital equipment, requires longer-term financing. It might be argued here that this type of credit is provided by special credit institutions, such as the Industrial Development Bank (in the case of manufacturing) and the Agricultural credit Corporation (in the case of agriculture). This is true; but the increasing demand for longer-term credit which accompanied development programmes is above the lending capacity of such specialised institutions as will be shown in Chapter 8. This situation requires the commercial banks to participate in meeting part of such new demands if they have to contribute effectively to the economic development of the country.

It was shown that the introduction of term lending into banking practice was justified on theoretical grounds. Moreover, the argument for term lending in the particular case of Jordan is not only necessitated by the increasing demand for such loans, but it is further encouraged by the structure and nature of bank deposits. As was shown earlier, about half of bank deposits is of a relative stable character, in the form of time and saving deposits, which banks can rely upon in extending longer-term facilities without endangering their liquidity. As Richard Bond argues :

> "The asset structure of a commercial bank is influenced to a considerable extent by its deposit structure. Time deposits, for example, tend to be more stable and predictable than demand deposits. As is well known, the greater stability of time deposits entices banks to place a greater proportion of these funds in high earnings, though less liquid assets."(1)

Furthermore, demand deposits in Jordan are not as fluid and volatile as their counterpart in the more developed countries, and even as compared with many developing countries. It was illustrated that due

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(1) Richard Bond, "Deposit Composition and Commercial Bank Earnings," Journal of Finance, (March 1971) P.41.

to many reasons, demand deposits in Jordan have a low turnover which indicates that they are used less, comparatively speaking, in a specific period of time. In other words, part of such deposits is, in effect, a disguised form of saving deposits which can further encourage longer-term business. Given all these favourable conditions, it is necessary for commercial banks to review and reconsider their lending policies to serve the growing requirements of the Jordanian economy. This does not mean that short-term lending by commercial banks is no longer important, but it is still essential for financing and smoothing various economic activities. What is required is not a complete departure from the traditional lending practice, but a partial deviation from strict orthodoxy necessitated by changing economic conditions. It is therefore suggested that term lending should not comprise the bulk of bank credit, thus transferring these banks into investment banks, rather it should comprise only a moderate proportion of their funds, which does not endanger their liquidity. This is consistent with what Williamson recommended for developing countries. In a lecture given at the Central Bank of Egypt in 1965, he emphasised that:

> "A portion of Commercial banks' funds can be tied up in various loans or investment which are a little longer than would be strictly justifiable on normal banking tests"(1)

One final point regarding the introduction of term lending practice in Jordan deserves mentioning. In asking them to extend longer-term loans, commercial banks may raise two major issues. Firstly, they may argue that they have already been contributing to financing longer-term purposes on informal basis. Although they extend credit only on short-terms, some of their sound loans are sometimes subject to renewal when they mature. Commercial banks in this practice are, in fact, following

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(1) G. I. Williamson, The Role and Practice of Commercial banks and other Institutions in Financing Development, (Cairo: National Bank of Egypt, 1965) P.11.

the British example of 'rolling-over' their short-term credit extended to reliable borrowers. However, although such a practice may contribute to financing longer-term needs, borrowers cannot depend on such an unpredictable source of funds for long-term purposes. In planning their future expansion, for example, businessmen want to make sure that long-term funds necessary for this expansion are certainly obtainable. Rolling-over short-term credit does not provide this assurance because such a practice is subject to annual review, which may deprive the borrower of using the loan for longer periods. This point was adequately explained by the Radcliffe Committee in Britain which emphasised that rolling-over short-term credit cannot meet long-term requirements as formal term lending because:

> "..... Bank overdrafts are however legally repayable on demand and in practice subject to review annually; and it seems that some borrowers consider that, because the overdraft is subject to annual review, and because they fear that the annual review may sometimes lead to a request for reduction of the overdraft, bank credit is too unreliable form of credit for medium and longer-term purposes."(1)

Secondly, banks may rightly also argue that if term lending practice is to be accepted, the Central Bank of Jordan should provide rediscounting facilities for long-term assets to secure bank liquidity in an emergency. This is a pre-requisite condition for encouraging commercial banks to venture into such new business. It is necessary to note here that central banking legislation in Jordan forbids the CBJ from providing commercial banks with rediscounting facilities for any financial instrument with maturities exceeding nine months.(2) Jordanian bank legislation, therefore, not only lacks legal enforcement of term lending by commercial banks (as was shown in recent bank legislation in many developing countries), but also discourages commercial banks from undertaking such

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(1) Committee on the Working of the Monetary System, Report Represented to Parliament by the Chancellor of the Exchequor by Command of Her Majesty. op.cit. Parag. 941.

(2) Central Bank of Jordan, Law No. 93 for 1966, Article 39-b

important business voluntarily. It will be shown in Chapter 11 that if term lending is to be encouraged, it is essential first to modify such an impediment to enable the CBJ to secure bank liquidity by rediscounting long-term financial instruments.

(b) <u>A distinct bias towards financing the general commerce and foreign trade sector at the expense of other important domestic activities</u>.

Commercial banks in Jordan are still heavily geared to the finance of the foreign trade sector which claimed the bulk of their credit, averaging 43.3% throughout the period 1964 - 1976.(1) The sectoral distribution of bank credit has not been significantly altered, even after 1973 when priority was given to promoting internal agricultural and manufacturing activities within comprehensive development programmes. As can be observed from Table 4.7, although the relative share of the foreign trade sector in total bank credit experienced a slight decrease, dropping from 49.2% to 44.4% between 1964 and 1976, it was still by far the predominent share. Another decline occurred in the proportion going to the transport sector which halved between the beginning and the end of the period, decreasing from 8.8% in 1964 to 4.3% in 1976. The decline in the relative share of the above two sectors was made up for mainly by the spectacular growth of the share that went in favour of the construction sector(2) - the percentage having jumped from 7.7% in 1964 to 16.8% in 1976. On the other hand, the relative importance of

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(1) See Table 4.7 which illustrates the relative shares of the main economic sectors in GDP as well as in bank credit. The aim here is to reveal whether the sectoral distribution of bank credit has been altered in line with the structural changes that occurred in the real economy. The analysis excludes the year 1977 because the actual figures for the relative contribution of economic sectors to GDP have not been published yet. However, the sectoral allocation of credit for 1977 is shown in Appendix 4.5 .

(2) This rise was in part due to a property boom that was related to the existence of high domestic rates of inflation during the last years of this period.

Table 4.7 The Relative weight of the main Economic Sectors in Both GDP and Bank Credit, 1964 - 1976

%

| Year | Wholesale and Retail Trade | | Agriculture | | Mining and Manufacturing | | Construction | | Transportation | |
|---|---|---|---|---|---|---|---|---|---|---|
| | % of GDP | % of Credit | % of GDP | % of Credit | % of GDP | % of Credit | % of GDP | % of * Credit | % of GDP | % of Credit |
| 1964 | 20.7 | 49.2 | 25.2 | 2.9 | 9.2 | 12.0 | 4.0 | 7.7 | 8.9 | 8.8 |
| 1965 | 20.8 | 51.3 | 22.6 | 2.0 | 10.7 | 13.0 | 5.2 | 7.4 | 8.4 | 7.0 |
| 1966 | 19.3 | 52.2 | 18.5 | 1.6 | 11.5 | 12.2 | 6.2 | 8.4 | 9.6 | 5.5 |
| 1967 | 22.1 | 44.6 | 21.9 | 2.0 | 9.9 | 10.9 | 4.9 | 12.9 | 8.4 | 4.6 |
| 1968 | 17.3 | 41.6 | 16.3 | 1.6 | 11.9 | 9.8 | 5.8 | 14.9 | 8.6 | 4.4 |
| 1969 | 19.3 | 42.0 | 18.3 | 1.6 | 11.6 | 9.3 | 5.5 | 15.7 | 8.1 | 3.4 |
| 1970 | 20.0 | 37.1 | 15.1 | 1.3 | 10.4 | 10.5 | 4.1 | 24.6 | 8.4 | 5.3 |
| 1971 | 19.3 | 40.4 | 18.7 | 1.7 | 10.1 | 9.8 | 3.7 | 22.4 | 8.0 | 5.6 |
| 1972 | 18.9 | 42.4 | 18.9 | 1.6 | 11.3 | 9.2 | 4.3 | 21.1 | 8.1 | 4.8 |
| 1973 | 18.8 | 40.5 | 13.3 | 3.3 | 11.9 | 10.2 | 6.5 | 23.4 | 8.4 | 3.6 |
| 1974 | 16.9 | 36.1 | 17.7 | 4.5 | 15.9 | 12.5 | 5.5 | 22.4 | 8.2 | 6.3 |
| 1975 | 16.3 | 42.3 | 10.0 | 3.0 | 18.1 | 12.4 | 6.0 | 21.6 | 9.3 | 3.0 |
| 1976 | 15.0 | 44.4 | 11.1 | 2.8 | 18.2 | 12.0 | 6.9 | 16.8 | 10.0 | 4.3 |
| Av. 1964-1976 | 18.8 | 43.3 | 17.5 | 2.3 | 12.4 | 11.1 | 5.3 | 16.9 | 8.6 | 5.1 |

Source: (1) For GDP Percentages, See Appendix 4.4

(2) For Bank Credit Percentages, See Appendix 4.5

* Includes credit for real estate purchase.

credit going to agricultural and manufacturing activities (sectors having priority in domestic development strategies) did not show any considerable change throughout the whole period. The relative size of credit extended to both sectors by 1976 ranged around the same level as in 1964. The relative share of agriculture in 1964 was as low as 2.9%, and continued around this level to account for 2.8% in 1976. The same experience occurred in the relative proportion going to the manufacturing industries which remained constant at 12% between 1964 and 1976.

Credit concentration in the foreign trade sector can be related, firstly, to the relatively high share of this sector in GDP and, secondly, to the fact that this has been a traditional area which commercial banks preferred to finance throughout their history. Although the relative importance of the foreign trade sector in GDP declined slightly from 20.7% to 15.0% between 1964 and 1976, this sector remained a major contributor to GDP, comprising an average ratio of 18.8% throughout the whole period. However, such a relative share, though substantial, was not as much as to absorb 43.3% of the total credit extended to all economic sectors. The above second factor may, therefore, provide another explanation for credit concentration in foreign trade activities. This has been further encouraged by the short-term nature of the credit required by this sector, which commercial banks have always preferred to finance.

A distinguishing feature of commercial banking in developing countries, nowadays, is the rising importance of the relative share of the manufacturing sector in total bank credit at the expense of the foreign trade sector.(1) This trend is consistent with the growing official interest towards diversifying and developing other domestic sectors of the economy, particularly manufacturing, within a comprehensive

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(1) S. Basu, A Review of Current Banking and Practice, op.cit. P.293

planning of economic development. As the economy grows and diversifies its activities, a shift in bank credit towards those sectors which are given prime priority occurs. India, Ghana, and Nigeria are cases where the distribution of bank credit has radically altered in response to the new structural change in their economies. In India, while the relative share of manufacturing and agriculture in total bank credit rose respectively from 34% and 2% in 1951 to 64% and 7% in 1970, the proportion going to commerce dropped significantly from 41% to 17% during the same period.(1) In Ghana, the decline in credit going to commerce from 37% in 1961 to 25% in 1965 was made up for by the noticeable rise in the relative share of agriculture which rose from only 5% to 22%.(2) Nigeria also provides a clear example where the relative importance of the traditional trade sector declined from 35% to 28% between 1958 and 1965, whereas manufacturing industry increased its share from 5% of total credit to 14% during the same period.(3)

However, this was not the case in Jordan where the sectoral distribution of bank credit has not been consistent with the emphasis placed on developing and diversifying the national economy. The proportion of bank credit going to the directly producing sectors, which have been emphasised by development programmes,(4) remained without any significant change despite the increase in their relative contribution to GDP. This is quite clear (as can be seen by Figure 4.4) in the case of the manufacturing sector which doubled its contribution to GDP

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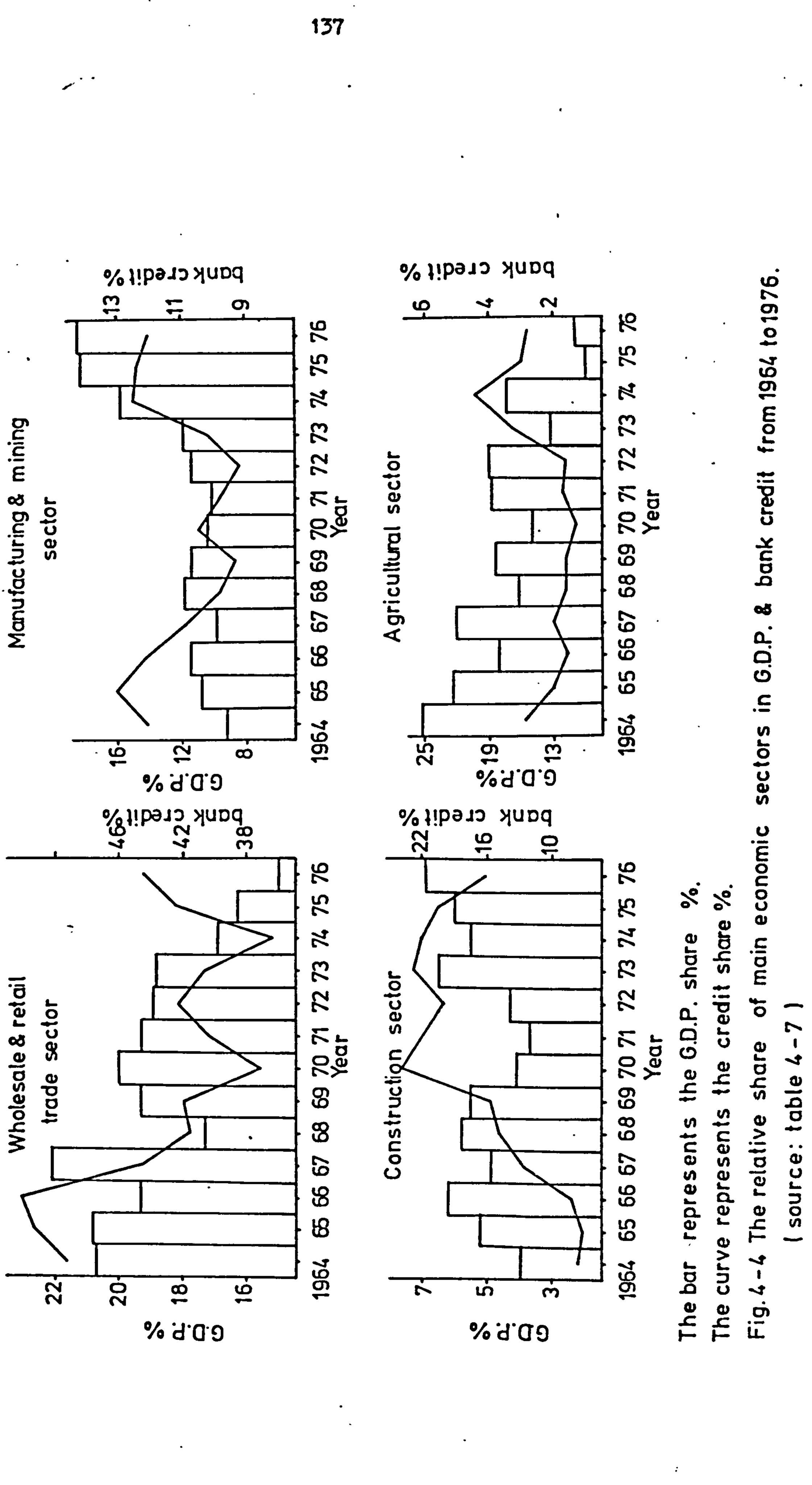
(1) Ibid, P.292

(2) S. Basu, Central Banking In the Emerging Countries, A study of African Experiments, (N.Y.: Asian Publishing House, 1967) P.33.

(3) Ibid. P.23

(4) For domestic development strategies and the significance given to directly producing sectors, see Chapter 3, PP. 59 - 61




The bar represents the G.D.P. share %.
The curve represents the credit share %.
Fig.4-4 The relative share of main economic sectors in G.D.P. & bank credit from 1964 to 1976.
( source: table 4-7 )

between 1964 and 1976 without a corresponding rise in its relative share in total credit, which remained constant at 12%. Although there was a slight increase in the relative share of this sector with the implementation of development programmes in 1973, this was clearly insufficient to match the increasing importance of this sector in GDP and the great emphasis placed by development strategies on promoting this sector. This situation reflects, firstly, the poor adaptation of the commercial banks to the changing needs of their economy and, secondly, the failure of the monetary authorities to sufficiently influence the allocation of bank credit in favour of developmental activities. It will be argued in Chapter 11 that, for the commercial banks to participate actively in development, their operations should be effectively planned along the lines laid down in economic development strategies. The pursuance of specific central banking innovations will be shown necessary to encourage and direct the flow of bank resources towards priority sectors, thereby promoting the required structural change in the real economy.

(c) Excessive liquidity holdings maintained by the Commercial Banks.

Prior to the creation of the CBJ, commercial banks were not subject to any law regulating their liquidity. Nevertheless, commercial banks conventionally maintained a high ratio of liquid assets (mainly in overseas forms) to deposits, averaging around 58% throughout the period 1951 - 1964.(1) The absence of liquidity regulations was ended in 1966 by the Temporary Banking Law which stipulated that bank holdings of specified liquid assets should range between 25% - 35% of total bank deposits.(2) The maximum ceiling on bank liquidity was removed in accordance with the Temporary Banking Law of 1971, which required the commercial banks to adhere to the minimum ceiling of 25%.(3) This was the case until August 1975, when the CBJ raised the minimum liquidity

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(1) J. Salah, The Evolution of the Banking System in Jordan, op.cit. P.42

(2) CBJ, Third Annual Report, 1966 P.8.

(3) CBJ, Temporary Banking Law No. 23 of 1971, Article 17-b

ratio to 30%.(1) In addition to specifying liquidity ratios, commercial banks were also required to hold a minimum percentage of their deposits in balances with the CBJ. Thus, in January 1967, commercial banks, for the first time in their history, became subject to a minimum cash ratio of 7%.(2) This ratio was raised to 10% in December 1970 and to 12% in August 1974.(3) Finally, starting from November 1976, the reserve ratio on demand deposits was raised to 15% whereas that imposed on time and saving deposits remained unchanged at 12%.(4)

An examination of Table 4.8 clearly reveals that commercial banks continued their conventional practice of maintaining high liquidity ratios, averaging around 44.3%, much higher than the statutory minimum specified by the CBJ (See Figure 4.5.a). This situation can be largely explained by the fact that commercial banks were still pursuing very cautious and conservative operational policies inherited from their past. The application of conservative lending criteria by many commercial banks, such as requiring high standards of creditworthiness and certain types of collaterals, undoubtedly minimised the opportunity for domestic investors to acquire adequate bank credit. This accordingly led commercial banks to accumulate larger proportions of their funds in liquid forms, much above the necessary and the offical desired level. As can be seen from the table, the level of free liquidity maintained by banks

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(1) CBJ, Twelfth Annual Report, 1975, P.34. However, the above ratio was temporarily raised to 32% in Dec. 1976 and to 35% starting in Jan. 1977. This was part of the stringent monetary policy which was followed in 1976 and was relaxed later in 1977. The liquidity ratio was again fixed at the previous level of 30%. See Chapter 11, P. 371

(2) CBJ, The Central Bank During Ten Years, op.cit. PP.66-67

(3) Ibid.

(4) See Chapter 11, P. 370

Table 4.8 Liquidity and Cash Reserve Ratios of Commercial Banks in Jordan, 1964 - 1977

(millions of JD)

| | | 1964 | 1965 | 1966 | 1967 | 1968 | 1969 | 1970 | 1971 | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | Average Ratio 1964-77 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1. | Total liquid Assets* of which: | 30.48 | 20.70 | 22.70 | 24.51 | 24.63 | 23.51 | 24.57 | 28.33 | 39.00 | 42.64 | 48.60 | 76.53 | 98.22 | 146.70 | |
| 1.A. | (Balances with the CBJ) | (0.34) | (7.80) | (13.27) | (16.94) | (15.67) | (12.58) | (12.86) | (14.86) | (17.27) | (16.76) | (21.97) | (32.91) | (50.60) | (62.87) | |
| 2. | Short-Term Liabilities** of which: | 52.94 | 47.63 | 55.43 | 54.94 | 56.25 | 59.06 | 60.85 | 67.17 | 79.49 | 92.68 | 119.78 | 176.14 | 250.04 | 305.69 | |
| 2.A. | (Deposits) | (48.47) | (44.10) | (52.84) | (53.39) | (54.18) | (57.40) | (57.67) | (59.65) | (72.89) | (85.75) | (111.98) | (158.04) | (227.24) | (283.81) | |
| 3. | Liquidity Ratio Col. (1)as % of Co.(2) | 57.6 | 43.5 | 41.0 | 44.6 | 43.8 | 39.8 | 40.4 | 42.2 | 49.1 | 46.0 | 40.6 | 43.3 | 39.3 | 48.0 | 44.3 |
| 4. | Minimum Liquidity Ratio | - | - | 25.0 | 25.0 | 25.0 | 25.0 | 25.0 | 25.0 | 25.0 | 25.0 | 25.0 | 30.0 | 30.0 | 30.0 | 26.3 |
| 5. | Excess Liquidity Ratio Co.(3) minus Co.(4) | - | - | 16.0 | 19.6 | 18.8 | 14.8 | 15.4 | 17.2 | 24.1 | 21.0 | 15.6 | 13.3 | 9.3 | 18.0 | 18.0 |
| 6. | Cash Reserve Ratio Co.(1.A.) as % of Col.(2.A.) | - | 17.6 | 25.0 | 31.7 | 28.9 | 21.9 | 22.3 | 24.9 | 20.7 | 19.5 | 19.6 | 20.8 | 22.3 | 22.2 | 23.0 |
| 7. | Minimum Cash Ratio | - | - | - | 7.0 | 7.0 | 7.0 | 10.0 | 10.0 | 10.0 | 10.0 | 12.0 | 12.0 | 13.5 | 13.5 | 10.0 |
| 8. | Free Cash Ratio Co.(6) minus Co.(7) | - | - | - | 24.7 | 21.9 | 14.9 | 12.3 | 14.9 | 10.7 | 9.5 | 7.6 | 8.8 | 8.8 | 8.7 | 13.0 |

Source: (1) For liquid assets Figures, Table 4.6

(2) For Liabilities Figures, See Table 4.1

* Domestic as well as foreign liquidity holdings. See Table 4.6

** Besides deposits, short-term liabilities consist of borrowing from the CBJ and other banks, in the Kingdom and abroad, and bills payable.

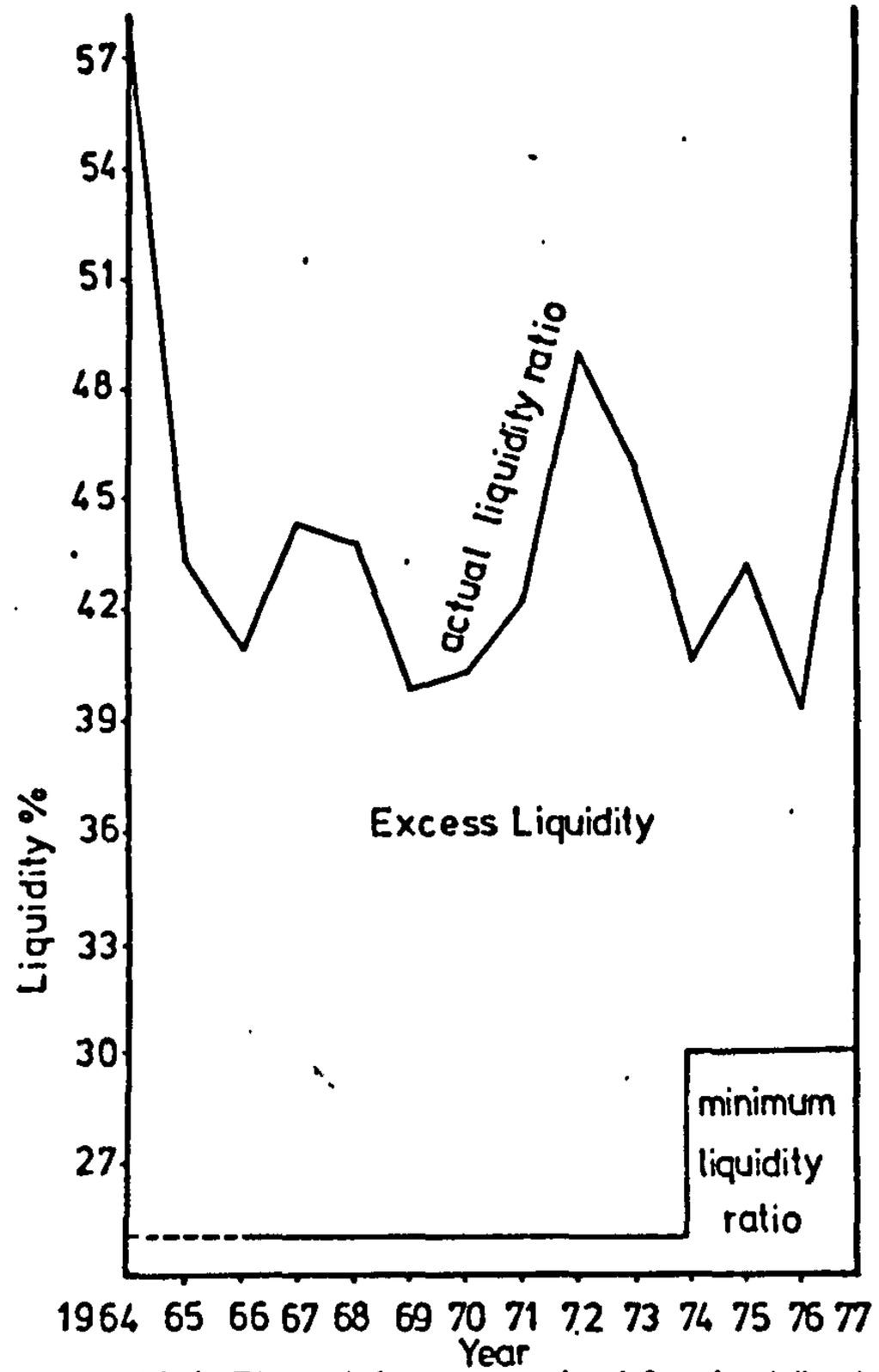


Fig. 4-5(A) The minimum required & actual liquidity maintaind in commereial banking from 1964 to 1977.

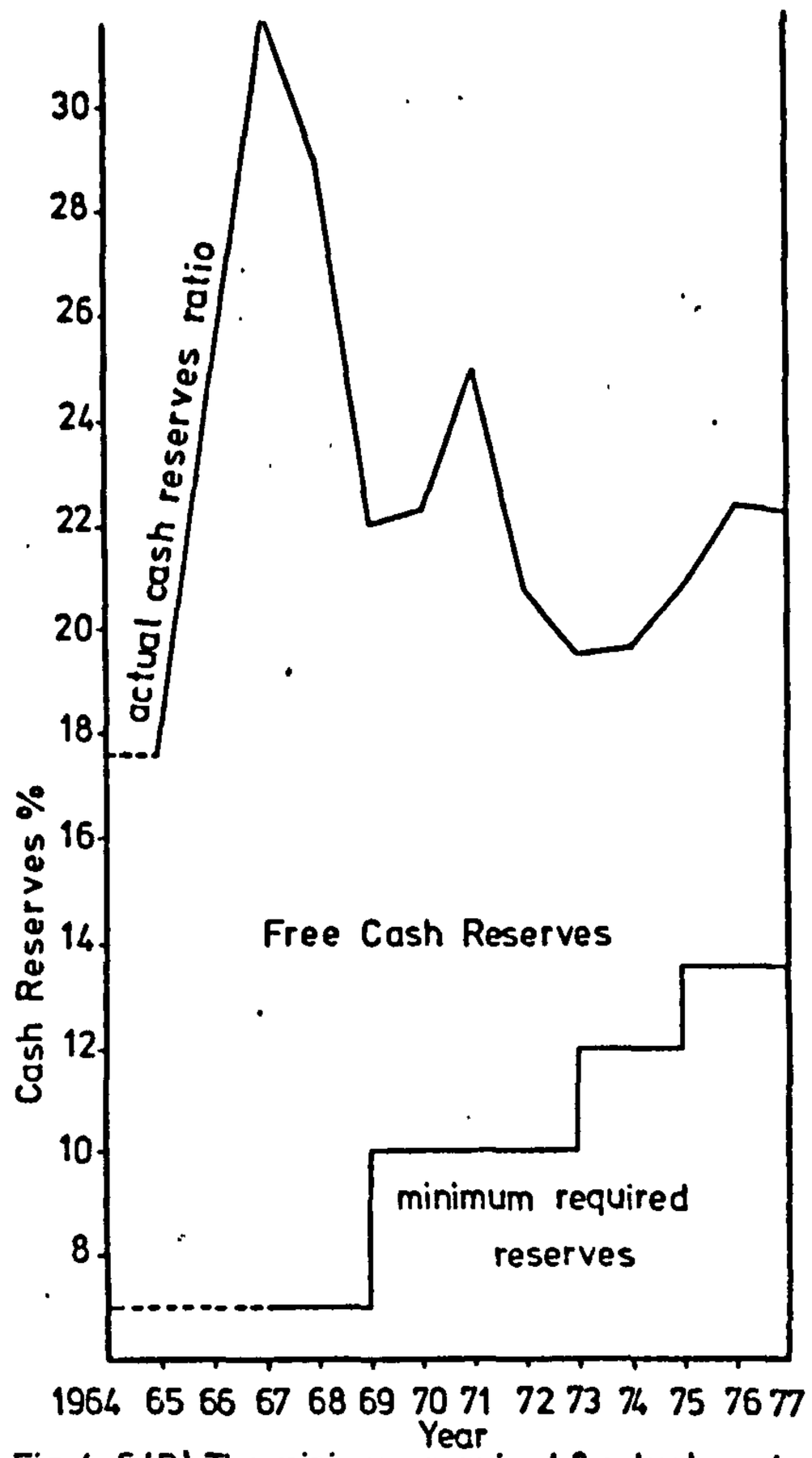


Fig. 4-5(B) The minimum required & actual cash reserves ratio in commereial banking from 1964 to 1977.

(dashed lines cover the periods which do not have data)

(source: table 4 - 8 )

(i.e. the amount of liquid assets in excess of the official minimum required) was substantially high, fluctuating around 18.0% throughout the whole period. This was more than half of the present legal minimum of 30%. Banks' conservatism, however, was encouraged by the political instability in the region, which further accentuated their desire to be very liquid.

Excessive liquidity in commercial banking was also intensified when commercial banks were allowed to deposit their funds with the CBJ and receive interest after the 1966 prohibition of overseas investment. Due to the lack of domestic outlets for short-term investment, the CBJ had, as a compensatory procedure, to provide such an alternative as a temporary solution until adequate domestic investment occurred. Nevertheless, the CBJ continued to pay interest on such deposits even when internal short-term investment became available.(1) It was not until 1974 that the CBJ stopped paying interest only on that part which kept within the minimum legal requirements.(2) Interest on free cash reserves continued to be paid. This undoubtedly further intensified bank liquidity and also discouraged commercial banks to seek investment in alternative domestic activities. As can be seen from the table, actual cash reserves accounted, on average, for 23.0% during the whole period, a ratio which was more than twice the average legal reserves required by the CBJ (See also Figure 4.5.b). Clearly, this behaviour reflected excessive prudential operational banking policies which were maintained despite the relatively low turnover of demand deposits as discussed earlier.

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(1) Treasury Bills, for example, were issued for the first time in 1969.

(2) CBJ, The Central Bank of Jordan During Ten Years, op.cit. P.67

Maintaining such high liquidity in domestic banking, particularly in the form of unnecessary cash reserves kept idle with the CBJ, has a special significance as a potential source of financing economic development. An excessive liquidity ratio of 18.0% and a free cash reserve of 13.0% have undoubtedly absorbed substantial proportions of bank funds which could be otherwise invested in domestic development activities. This situation calls on development planners, together with the monetary authorities, to make a full use of such potentialities within further planning of the part that the financial system should play in economic development.

It is important to mention here that the level of liquidity in domestic banking varied widely among individual banks. Such differences were not only related to orthodoxy or conservatism in banking practice, but they could be also explained by certain characteristics pertaining to the structure of the bank balance sheet. Changes in these characteristics or factors from one bank to another, or within the same bank over time, may lead to different positions of liquidity among banks. However, due to the significance of excessive liquidity holdings as a major operational deficiency in commercial banking in Jordan, and because of the important implication of this situation for economic development, it is found useful to analyse and discuss the liquidity behaviour of the commercial banks in more detail. This will be the concern of Chapters 5 and 6.

## Summary and Conclusions

This chapter has analysed and then assessed commercial banking activity in Jordan with special reference to domestic economic development. The analysis demonstrated that commercial banks have played an important, though still insufficient, role in carrying out and facilitating the saving-investment process through their intermediation between the sources of funds and their ultimate uses. As mobilisors

of funds, although these banks made notable progress (made evident by the rise in both the deposits/GNP ratio and the banking density ratio), nevertheless, little has been achieved in two major areas of operation. (1) The mobilisation of untapped sources of savings in remote and rural regions. (2) The introduction of new effective methods or techniques for encouraging a continuous influx of resources to the banking system. On the one hand, there was a clear absence of adopting effective advertisement and saving campaigns which would have been useful in attracting additional funds. On the other hand, there was a failure to offer real and attractive returns on bank deposits, thus discouraging further financialisation of domestic resources. As allocators of funds, commercial banks have not shown any significant adaptation of their operational lending practice to match the changing domestic needs. They displayed an obvious reluctance to venture beyond their traditional boundaries and did not therefore pursue innovational lending policies which were crucial to their economy. The sectoral distribution of bank credit was still not consistent with the new trend towards the diversification and industrialisation of the domestic economy. Moreover, commercial banks have not been successful in transforming the relatively more stable time and saving deposits into instruments of medium and long-term finance. This situation was exacerbated by maintaining high liquidity in commercial banking, particularly in idle cash reserves held with the CBJ, which further minimised the flow of funds into productive channels. Given all these functional deficiencies, it is easy to understand the significance of the points that have been raised earlier, particularly with regard to the need for (1) introducing adequate financial innovations to improve banks' operational efficiency as mobilisers as well as allocators of funds, and (2) proper and detailed planning of the financial operations of these institutions within the general framework of development programmes.

It will be shown in Chapter 11 that, while effective participation of the commercial banks in domestic development requires them to further adapt to the changing needs of their economy, this should be facilitated and encouraged by the CBJ which has to provide the appropriate financial climate for the readjustment process to take place. Central banking actions will be shown also necessary to exercise a vigorous influence over the allocation pattern of bank resources to bring it in line with the selected development strategies.

However, prior to this, the liquidity behaviour and balance sheet structure of the commercial banks, together with the policy implications of their excess liquidity balances need to be examined in more depth.

# CHAPTER 5

## LIQUIDITY BEHAVIOUR AND THE BALANCE SHEET STRUCTURE OF COMMERCIAL BANKS

The preceding chapter has already demonstrated that commercial banks in Jordan have always maintained excessive liquidity holdings, much above the officially desired levels. However, a close examination of individual banks' liquidity reveals wide differences in liquidity positions. Although all banks are subject to the same framework of regulations specifying the quantity and the quality of the minimum liquidity ratio, individual banks behaved in distinctly different ways; some maintaining very high liquidity, while others kept their liquidity within moderate levels.(1) The general outcome was that the liquidity of the commercial banks as a whole was remarkably high.

In general, liquidity variations among banks can be related to two main types of factors -

(1) Institutional factors. Liquidity considerations vary from one bank to another because of differences in bank managements' psychological propensity to avoid or to accept risk. In other words, whether bank managers are risk-takers or risk-avoiders can largely influence asset portfolio decisions of individual banks and thus their liquidity positions. As will be shown later, two distinct groups of bank management exist in Jordan. On the one hand, there are 'conservative' banks which tend to pursue orthodox and very cautious lending policies, confining their activities to traditional and well-established lines of business. On the other hand, there are 'aggressive' banks that

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(1) In a few cases, banks maintained negative excess liquidity (i.e. operating at a level of liquidity lower than the officially prescribed level).

are less inhibited by traditions and more innovative in domestic banking practice. Clearly, conservatism and over-cautiousness on the part of the former lead to maintaining excessive liquidity, whereas the more dynamic approach of banking adopted by the latter results in operating at comparatively lower liquidity levels.

(2) Balance sheet factors. Variation in liquidity amongst banks can also be explained by differences in the structure and the relationship between the main components of the bank balance sheet. Selected balance sheet attributes have been suggested in the literature as having explanatory possibilities of liquidity behaviour. Bank-to-bank variations in these characteristics (such as bank size, bank growth rate, ratio of time deposits to total deposits, and the capital to deposit ratio) lead to maintaining varying liquidity by banks.

The impact of the institutional factors on liquidity behaviour is difficult to measure in quantitative terms. This analysis will therefore be confined to examining the influence of the balance sheet factors on bank liquidity. The aim is to investigate to what extent the structure of the bank balance sheet and the relationship between certain assets and liabilities necessitate holdings of excessive liquidity. The analysis will also reveal the extent to which the bankers in Jordan are pursuing rational balance sheet management. The findings of this chapter will have a special significance in suggesting specific policy implications (chapter 6) for increasing the contribution of the commercial banks to the economic development of the country. However, before examining the influence of the balance sheet structure on bank liquidity behaviour (section II), it is necessary first to analyse (in section I) some basic features of the banking industry in Jordan.(1)

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(1) It is important to indicate that the detailed statistics used in this chapter are not derived from published materials but were directly obtained from the Banking Control Department of the CBJ. These statistics were provided on the condition that the names of individual banks were not mentioned.

# I

## Basic Features of Jordanian Banking

In general, three outstanding features of commercial banking can be distinguished in Jordan -

(1) Concentration of bank activities within a few banks. As is clearly shown by Table 5.1, one big bank (Bank A) was responsible for 42.3% of total deposits and 41.7% of total credit furnished by the banking system in 1976. This was followed by Bank H which claimed 14.5% and 16.4% of total deposits and credit respectively. Bank D was also important with respective relative shares of 10.4% and 15.8% of total bank deposits and credits. The big three banks together were therefore responsible for more than two thirds of total deposits (67.2%) and slightly less than three quarters of total credit (73.9%).

At the same time, the big three banks seem to have the highest loan/deposit ratio, ranging from 120.7% for Bank D to 89.7% and 78% for both banks H and A respectively. Here, it should be mentioned that banks are subject to certain limitations on credit extension. All banks have to observe the maximum loan/deposit ratio specified by the monetary authority. The maximum legal ceiling was altered during the period under review due to changing economic circumstances. During the early years of its operations, the CBJ was interested in repatriating overseas funds transferred abroad by the banking system throughout the previous period of monetary dependence. During the period of the Currency Board System, the actual loan/deposit ratio averaged around 57.4%.(1) In order to strengthen the domestic credit

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(1) J. Salah, The Evolution of the Banking System in Jordan, op.cit. P.71.

Table 5.1 Individual Banks' Activities as of December 31, 1976*

(In millions of J.D.)

| Bank** | Loans | | Deposits | | Loans Deposits Ratio (3)=(1)÷(2) | Actual Liquidity Ratio (4) | Minimum Legal Requirment (5) | Excess Liquidity Ratio (6)=(4) - (5) |
|---|---|---|---|---|---|---|---|---|
| | Amount (1) | % of Total | Amount (2) | % of Total | | | | |
| A | 74.58 | 41.7 | 95.45 | 42.3 | 78.1 | 28.0 | 30.0 | -2.0 |
| B | 11.11 | 6.2 | 16.72 | 7.4 | 66.4 | 44.9 | 30.0 | 14.9 |
| C | 12.48 | 7.0 | 17.76 | 7.9 | 70.3 | 42.7 | 30.0 | 12.7 |
| D | 28.32 | 15.8 | 23.46 | 10.4 | 120.7 | 49.1 | 30.0 | 19.1 |
| E | 4.97 | 2.8 | 7.62 | 3.4 | 65.2 | 33.9 | 30.0 | 3.9 |
| F | 1.31 | 0.7 | 2.09 | 0.9 | 62.6 | 78.7 | 30.0 | 48.7 |
| G | 1.95 | 1.1 | 4.32 | 1.9 | 45.1 | 73.8 | 30.0 | 43.8 |
| H | 29.37 | 16.4 | 32.76 | 14.5 | 89.7 | 25.4 | 30.0 | -4.6 |
| I | 6.73 | 3.8 | 13.91 | 6.2 | 48.4 | 65.6 | 30.0 | 35.6 |
| J | 3.33 | 1.9 | 4.45 | 2.0 | 74.8 | 49.1 | 30.0 | 19.1 |
| K | 0.83 | 0.5 | 1.53 | 0.7 | 54.2 | 56.2 | 30.0 | 26.2 |
| L | 3.72 | 2.1 | 5.47 | 2.4 | 68.0 | 63.8 | 30.0 | 33.8 |
| Total Banks | 178.70 | 100.0 | 225.54 | 100.0 | 70.3 | 37.3 | 30.0 | 7.3 |

Source: Central Bank of Jordan, Banking Control Dept. (Unpublished Data).

* Figures are only for the East Bank of Jordan

** Due to secrecy purposes, individual banks are shown in symbols.

base, the CBJ in 1968 specified a high maximum ratio of 85% to be observed by the commercial banks.(1) Since 1973, however, the CBJ has ceased to be interested in increasing the volume of domestic credit, which was largely responsible for the notable rise in the money supply. As will be shown in Chapter 11, the rapid increase in bank credit after 1973 has largely induced inflationary conditions which led the CBJ to adopt many measures to restrict the credit extended by banks. Among these measures was the reduction in the loan/deposit ratio to 80% in 1974, which was further reduced to 75% during the first half of 1976 and to 70% during the rest of the year.(2) However, in spite of the fact that all banks had to observe a unified maximum ratio, Table 5.1 clearly shows that individual banks tended to behave in widely differing ways. The actual ratio ranged from a low level of 45.1% in the case of Bank G to a high level of 120.7% in the case of Bank D.(3) One main reason for such variations lies in bank management portfolio selection, which varies from bank to bank. In general, it can be said that banks with aggressive management usually maintain high loan/deposit ratios, while those with conservative behaviour tend to keep a low ratio between loans and deposits.

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(1) The CBJ, Memorandum No. 60/68 of 1968.

(2) It will be shown in Chapter 11 that the CBJ removed all credit restriction imposed on commercial banks, starting from August 1977.

(3) Bank regulations do not reveal any penalty imposed on banks who surpass the maximum loan/deposit ratio. The CBJ in such cases depends on moral persuasion asking such banks to adjust their loan/deposit ratios within the prescribed level. However, in the case of Bank D, the unusual high percentage between credit and deposits was in fact due to special circumstances associated with the bank in the past. Part of the credit extended by the bank to certain customers a few years ago is still now unpaid. This comprised about one quarter of total credit outstanding. Undoubtedly, such a situation led to an unusual rise in the loan/deposits ratio. However, even if this proportion of unpaid loans was excluded from total credit outstanding, Bank D still claimed the highest percentage between credit and deposits with a ratio of 95%.

(2) The maintenance of widely different levels of excessive liquidity amongst individual banks, ranging from a negative level of 4.6% in the case of Bank H to 48.7% in the case of Bank F. Such bank-to-bank liquidity variations can be related to both the institutional and the balance sheet factors as mentioned earlier. However, it is important to mention here that all banks are subject to unified liquidity regulations. Each bank has to maintain a minimum liquidity ratio which in August 1975 was raised from 25% to 30%.(1) The CBJ was also empowered to penalize any bank which keeps liquidity below the minimum specified ratio. Article 17 of the Temporary Banking Law of 1971 reveals that the CBJ could impose a penalty rate of $\frac{1}{3650}$ on the difference between the minimum fixed level and the actual liquidity maintained. This should be applied daily as long as the deficit exists. Moreover, the Law empowered the CBJ to apply (in addition to the penalty rate) other serious punishments if the bank frequently keeps its liquidity below the legal minimum.(2)

A high loan/deposit ratio indicates risk-taking on the part of bank management, whereas a high excess liquidity ratio reflects risk-aversion.(3) This means that banks with a higher loan/deposit ratio would tend to have a lower excess liquidity ratio. This was the general trend in Jordan except for a few cases as is shown by Figure 5.1. Given the high loan/deposit ratio of the big three banks, it is therefore expected that these banks would have a low excess

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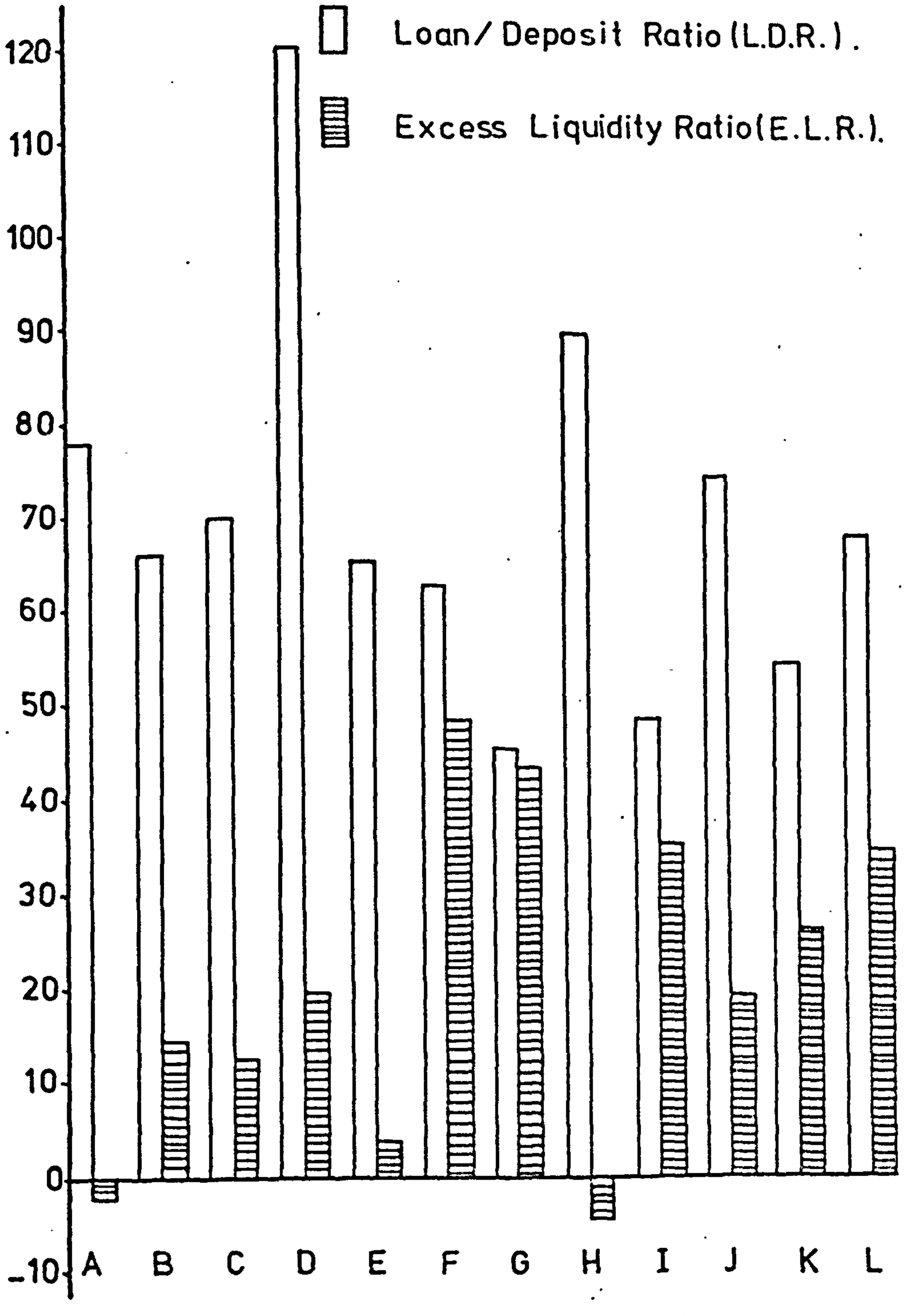
(1) See Chapter 4, P. 138

(2) In such cases, the CBJ may, according to the Law, restrict bank activities or even cease its license to operate in the country.

(3) Deane Carson and Ira Scott, Jr., "Commercial Bank Attributes and Aversion to Risk", P.425 & P.430.




Symbols A to L refer to individual banks.

Fig. 5-1 Loan/Deposit Ratio and Excess Liquidity Ratio of Individual Banks (1976).
(source : table 5-1 )

liquidity ratio. As is clearly shown by the Figure, this was true for both banks A and H which operated at negative excess liquidity ratios of 2.0% and 4.6% respectively, whereas this was not the case in Bank D which maintained excess liquidity of 19.1%. The behaviour of the latter seems paradoxical in view of the above relationship between the two ratios.(1) However, the lower liquidity ratio maintained by bigger banks, in general, is consistent with the future findings later in this chapter, which reveal that bank size is the dominant factor in the balance sheet that determines bank liquidity.

Classifying commercial banks according to nationality, there were at the end of 1976 (the recent year for which the detailed statistics were available) four Jordanian banks, three Arab banks, and five foreign banks.(2) Table 5.2 demonstrates that Jordanian banks dominate bank activities, claiming on average 68.8% of total bank deposits and 70.2% of total bank credit during the period 1967-1976. Next in importance are the foreign banks whose relative share in total bank deposit and credit averaged around 23.6% and 22.8% during the same period. The Arab banks were responsible for the remaining percentage of 7.6% of total deposit and 7.0% of bank credit. One obvious difference between the three groups of banks was that Jordanian banks in general tended to follow more liberal and aggressive lending policies as compared with both the Arab and foreign banks.(3)

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(1) This might have resulted from the special circumstances attached to this bank as discussed earlier, see footnote (3) P.150

(2) See Appendix 4.3

(3) The comparison applies only for all banks within each group which may not necessarily reflect the situation in individual banks. In other words, if banks were taken individually, some foreign banks may demonstrate more aggressive lending policies than some of the Jordanian banks. Thus although in theory the general expectation would be that foreign banks would not be too involved with indigenous investment, in practice Jordan is an exception to this due to the long historical presence of particular banks and their local knowledge of and participation in its domestic economic affairs.

Table 5.2 Loans/Deposits Ratio of Commercial Banks According to Nationality, 1967-1976*

(In millions of J.D.)

| Year | Loans | | | | | | | | Deposits | | | | | | | | Loans/Deposit Ratio | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Jordanian Banks | | Arab Banks | | Foreign Banks | | Total | | Jordanian Banks | | Arab Banks | | Foreign Banks | | Total | | Jordanian Banks | Arab Banks | Foreign Banks | Total Banks |
| | abs. | % of total | abs. | % of total | abs. | % of total | abs. | % | abs. | % of total | abs. | % of total | abs. | % of total | abs. | % | | | | |
| 1967 | 27.62 | 71.0 | 2.20 | 5.7 | 9.09 | 23.3 | 38.91 | 100.0 | 39.61 | 72.0 | 3.29 | 6.0 | 12.09 | 22.0 | 54.99 | 100.0 | 69.7 | 66.8 | 75.2 | 72.6 |
| 1968 | 30.05 | 71.4 | 3.58 | 8.5 | 8.45 | 20.1 | 42.08 | 100.0 | 39.88 | 71.0 | 4.08 | 7.3 | 12.16 | 21.7 | 56.11 | 100.0 | 75.4 | 87.7 | 69.5 | 75.0 |
| 1969 | 33.71 | 76.4 | 2.86 | 6.5 | 7.54 | 17.1 | 44.11 | 100.0 | 42.18 | 72.6 | 4.45 | 7.7 | 11.44 | 19.7 | 58.07 | 100.0 | 79.9 | 64.3 | 65.9 | 76.0 |
| 1970 | 33.42 | 74.3 | 3.08 | 6.9 | 8.22 | 18.4 | 44.72 | 100.0 | 43.76 | 66.3 | 9.08 | 13.7 | 13.20 | 20.0 | 66.04 | 100.0 | 76.4 | 33.9 | 62.3 | 67.7 |
| 1971 | 34.31 | 73.6 | 3.35 | 7.2 | 8.95 | 19.2 | 46.61 | 100.0 | 42.80 | 67.2 | 4.86 | 7.6 | 16.00 | 25.2 | 63.66 | 100.0 | 80.2 | 68.9 | 55.9 | 73.2 |
| 1972 | 34.93 | 68.2 | 4.60 | 9.1 | 10.97 | 21.7 | 50.50 | 100.0 | 50.55 | 74.8 | 5.28 | 7.8 | 11.74 | 17.4 | 67.57 | 100.0 | 69.1 | 87.1 | 93.4 | 74.7 |
| 1973 | 39.30 | 64.4 | 5.07 | 8.3 | 16.69 | 27.3 | 61.06 | 100.0 | 56.56 | 65.1 | 5.96 | 6.9 | 24.31 | 28.0 | 86.84 | 100.0 | 69.5 | 84.8 | 68.7 | 70.3 |
| 1974 | 53.81 | 63.7 | 5.96 | 7.1 | 24.64 | 29.2 | 84.41 | 100.0 | 73.49 | 65.0 | 6.86 | 6.1 | 32.69 | 28.9 | 113.04 | 100.0 | 73.2 | 86.9 | 75.4 | 74.7 |
| 1975 | 82.33 | 67.5 | 7.49 | 6.1 | 32.17 | 26.4 | 121.99 | 100.0 | 105.81 | 66.4 | 10.04 | 6.3 | 43.58 | 27.3 | 159.43 | 100.0 | 77.8 | 74.6 | 71.5 | 76.5 |
| 1976 | 126.48 | 70.8 | 8.24 | 4.6 | 43.98 | 24.6 | 178.70 | 100.0 | 153.40 | 68.0 | 14.03 | 6.2 | 58.11 | 25.8 | 225.54 | 100.0 | 82.5 | 58.7 | 75.7 | 79.2 |
| Average 1967-1976 | | 70.2 | | 7.0 | | 22.8 | | 100.0 | | 68.8 | | 7.6 | | 23.6 | | 100.0 | 75.4 | 71.4 | 71.4 | 74.0 |

Source: Central Bank of Jordan, Banking Control Dept., (Unpublished Data).

* Figures are for the East Bank of Jordan only.

This fact was clearly reflected in the loan/deposit ratio which recorded an average of 75.4% throughout the period under review, whereas the ratio for the Arab and foreign banks averaged around 71.4%.

The higher loan/deposit ratio maintained by Jordanian banks was associated with a lower excessive liquidity ratio, as compared with the Arab and foreign banks. Table 5.3 illustrates that Jordanian banks' holdings of excessive liquidity accounted for21.5%, as compared with an average of 48.9% for Arab banks and 24.8% for foreign banks. The lower liquidity maintained by the Jordamian banks supports the above explanation that these banks followed more aggrèssive lending policies which absorbed part of their excess liquidity.(1)

(3) A recent rising trend of keen competition in domestic commercial banking. This competition effectively took place with the introduction of new banks, starting with the domestic establishment of the First City Bank in 1973. This was followed by the introduction of another foreign bank in 1975, when the Bank of Credit & Commerce International was allowed to conduct operations in Jordan. The degree of competition was further intensified in 1976 and 1977, when the CBJ licensed four other new banks to operate in the country. One of these banks was foreign, while the remaining three were Jordanian.(2) This led to an

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(1) For the difference in the behaviour of the above ratios amongst the three goups of banks, see Figure 5.2

(2) These banks are:
1. Chase Manhattan Bank (started in 1976).
2. Jordan-Kuwait Bank (1977).
3. Jordan-Gulf Bank (1978).
4. Petra Bank (Under Establishment).

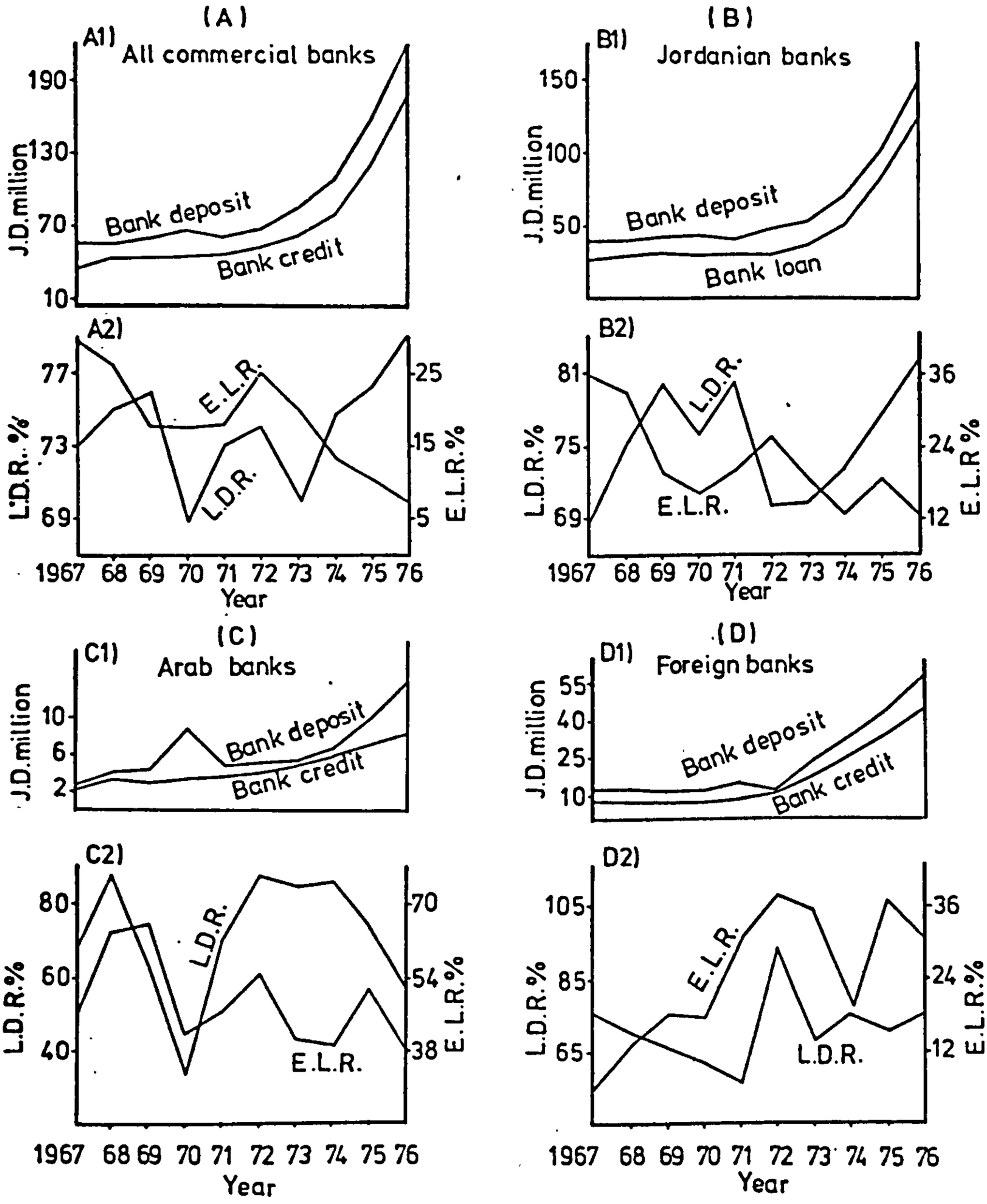
Table 5.3

Excess Liquidity Maintained by Commercial Banks Classified According to Nationality of Bank, 1967 - 1976*

| Year | Actual Liquidity Ratio (1) | | | | Minimum Liquidity Requirements (2) | Excess Liquidity Ratio (3)=(1)-(2) | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Jordanian Banks | Arab Banks | Foreign Banks | Total | | Jordanian Banks | Arab Banks | Foreign Banks | Total |
| 1967 | 60.6 | 69.5 | 31.5 | 55.1 | 25.0 | 35.6 | 44.5 | 6.5 | 30.1 |
| 1968 | 58.1 | 89.1 | 39.5 | 51.1 | 25.0 | 33.1 | 64.1 | 14.5 | 26.1 |
| 1969 | 45.4 | 91.5 | 43.1 | 42.9 | 25.0 | 20.4 | 66.5 | 18.1 | 17.9 |
| 1970 | 41.6 | 67.0 | 42.9 | 41.5 | 25.0 | 16.6 | 42.0 | 17.9 | 16.5 |
| 1971 | 45.3 | 71.7 | 55.5 | 42.8 | 25.0 | 20.3 | 46.7 | 30,3 | 17.8 |
| 1972 | 50.7 | 80.3 | 62.8 | 49.9 | 25.0 | 25.7 | 55.3 | 37.8 | 24.9 |
| 1973 | 43.9 | 66.2 | 60.5 | 45.6 | 25.0 | 18.9 | 41.2 | 35.5 | 20.6 |
| 1974 | 38.4 | 64.5 | 45.1 | 38.5 | 25.0 | 13.4 | 39.5 | 20.1 | 13.5 |
| 1975 | 48.9 | 81.9 | 67.0 | 40.7 | 30.0 | 18.9 | 51.9 | 37.0 | 10.7 |
| 1976 | 42.7 | 67.5 | 60.4 | 37.4 | 30.0 | 12.7 | 37.5 | 30.4 | 7.4 |
| Average 1967 - 1976 | 47.5 | 74.9 | 50.8 | 44.6 | | 21.5 | 48.9 | 24.8 | 18.6 |

Source: Central Bank of Jordan, Banking Control Dept. (Unpublished Data)

* Figures for East Bank of Jordan only.




E.L.R.= Excess Liquidity Ratio

L. D.R.= Loan/Deposit Ratio

Fig. 5-2 Deposit, credit, loan / deposit ratio & excess liquidity ratio in the three groups of banks classified according to nationality from 1967 to 1976.
(source : table 5-3 )

increase in the number of the commercial banks operating in the country to 15 by the end of 1977!

Prior to 1973, the market was shared by nine commercial banks which were operating in the country for many years. The market for both credit and deposit was largely dominated by the old and well-established banks, which had their traditional customers, either as depositors or borrowers. Market competition was not keen. Usually, competition in the financial system takes the form of interest rate competition, or it occurs through the provision of services.(1) Interest rate competition was not in fact active, given the fixed interest rate policy that has been traditionally adopted in Jordan together with lower activity in the market for both the credit and deposit sides. The market for bank credit was constrained by a maximum ceiling of %, which has been fixed by law.(2) Banks in Jordan charge extra rates on their credit as commission. As is well known, the major source of revenue for banks comes from the margin between their lending and borrowing rates of interest. The margin, or what is sometimes called the cost of intermediation, must cover the actual operating expenses, taxation, the earning of a surplus to build up reserves and the profits distributed to banks' shareholders.(3) Fixing the maximum credit rate did not leave wide room for banks to compete for attracting deposits by offering competitive rates of interest. Moreover, the market experienced a comparatively slow growing demand for bank services as compared with the later period which accompanied development programmes. This situation further minimised the

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(1) Jack Revell, The British Financial System, op.cit. P.93.

(2) Domestic interest rate policy is fully discussed in Chapter 11

(3) Jack Revell, The British Financial System, op.cit. P.100.

opportunities for interest rate competition. As far as the provision of services was concerned, banks did not also show active competition. This form of competition consists of offering a number of ancillary facilities which make dealing with one bank more attractive than another offering the same interest rate.(1) This can be done by providing easier and quicker withdrawal facilities and by extending the network of bank branches to serve a wider proportion of population. Banks in Jordan showed little competition in this area since withdrawal facilities in all banks should go through a routine and somehow long procedures.(2) However, some competition might have occurred through the extension of bank branches. A number of commercial banks adopted an expansionary branch policy which enlarged their relative share in the market.(3)

Keener competition has been brought to bear within the commercial banking system as a result of the permission given to the forementioned new banks to start operations in the country. These banks competed with the already existing ones in both the credit and deposit sides of the market. The new foreign banks were backed by their well-known international reputation which made it easier for them to enter the market.(4) The rest of the new banks were, in fact, all joint ventures with the majority of 60% of the equity held by Jordanians, and the

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(1) Ibid. P.96.

(2) The procedures for cash withdrawals are usually long, especially if compared with the developed countries, such as the U.K. The client is always required to present his identity card or to ask one of the staff members to vouch for his identity to the cashier. In both cases, the customer has to wait until his balance is checked. Moreover, he has to sign on the back of the cheque, besides the information taken from his identity card.

(3) For the extention of bank branches of individual banks, see Appendix 4.3.

(4) Clearly, Citibank, Bank of Credit and Commerce International and the Chase Manhattan Bank are all branches of wide international banking.

remaining 40% by other Arab financial interests.(1) The introduction of these banks to the market was largely facilitated by their high level of capitalisation.(2) However, the rising number of the commercial banks operating in the country created highly competitive conditions in the domestic market. This was further encouraged by an active demand for bank services resulting mainly from the execution of economic development programmes. Although there was some kind of competition in the provision of bank services (particularly in the form of bank expansion), the major area of competition was by varying the cost of loans and the yield on deposits. On the credit side, although the maximum legal ceiling of 9% was still operating, active competition among banks occurred through changing the commission rate. Banks were able to attract new customers for loans mainly by varying the rate of commission charged, which fluctuated between ½% and 2%. On the deposit side, the degree of competition was even keener. The introduction of the new banks led to fierce competition to attract funds from the local market. By offering higher interest rates on deposits, these banks succeeded in shifting part of the existing deposits from the older banks. Depositors began to shop around seeking higher yields on their funds. The older banks had to raise their deposit rates in order to keep their customers. Thus the system became much more competitive as compared with the pre-1973 period.

However, despite some advantages that must have resulted from the higher competitive banking environment (particularly in attracting further resources to the banks and improving the quality of bank

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(1) Middle East Communicators, "Jordanian Banking and Finance, 1978", (Amman: Jordan Times, Sunday, March 19, 1978) P.3

(2) The authorised capital of these banks were as follows: 1. Jordan-Kuwait Bank (JD 5 million). 2. Jordan-Gulf Bank (JD 5 million). 3. Petra Bank (JD 3 million). According to the Middle East communicators, the authorised capital of the above three banks was almost equal the paid-up capital of the remaining twelve banks operating in the country. See Ibid.

services), the recent fierce competition for funds left an unhealthy impact on the composition of deposits. Since they were in need of funds, the new banks offered competitively high rates of interest even on those deposits held on demand. Some new banks, especially the foreign ones, found it more profitable to attract such deposits by offering interest rates reaching 5%, than borrowing from overseas markets against higher rates. However, paying interest on current accounts is undesirable banking practice. By offering such a high rate of interest on current accounts, almost equivalent to those paid on term deposits,(1) people found it more convenient to keep their money on demand because they yield similar interest to those of other deposits. This discouraged any considerable growth in the relative size of the more stable type of deposits as represented by time and saving accounts. During 1964-1967, the relative importance of these deposits in the deposits structure rose only slightly, increasing from 47% to 49.8%.(2) Clearly, economic development requires a substantial shift in favour of term deposits which can be utilised for financing the long-term developmental needs. However, in a realisation of the adverse effect of competition on the composition of deposits, the CBJ issued a memorandum in 1977, fixing the maximum ceiling of interest on demand deposits at 2%, and the minimum rates on both saving and time deposits at $5\frac{1}{4}$% and $5\frac{1}{2}$% respectively.(3) This action must have minimised the degree of competition for demand deposits, whereas it left the door widely open to compete for term deposits by offering them higher interest rates.

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(1) See Chapter 4, P.97

(2) See Chapter 4, Table 4.2, P.98

(3) CBJ, Memorandum No. 31/78 (Feb. 2nd, 1978).

## II

## A Model of Jordanian Bank Liquidity Behaviour

A selected set of factors in the bank balance sheet has been suggested in the literature as being significant in determining the liquidity behaviour of individual banks. The purpose of this section is to investigate whether, and to what extent, these factors are responsible for explaining variations in bank liquidity in the Jordanian context.

It should be recalled here that the analysis is confined to the influence of the balance sheet factors on bank liquidity. Other institutional factors (mentioned at the outset of the chapter) which may largely influence bank liquidity, are excluded from the analysis. Moreover, the model also excludes any exogeneous influences, such as economic and political factors,(1) which can largely affect liquidity considerations of the commercial banks.

### 1. Theoretical Framework.

Existing literature points to four main factors in the bank balance sheet as having explanatory possibilities for liquidity

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(1) External monetary impacts are also excluded, such as: (a) changes in interest rates on alternative assets which may change the structure of bank assets and its liquidity holdings. However, due to a relatively rigid interest rate policy adopted in Jordan, this factor does not seem important in determining Jordanian bank liquidity. (b) Alterations in the minimum liquidity requirements which can also influence liquidity behaviour. As shown in Chapter 4, the minimum required ratio was changed only once during the period under review, rising from 25% to 30% in 1975. However, one would not expect such a change of being important in determining liquidity behaviour because banks, in general, have almost always maintained their actual liquidity well above the legal minimum.

behaviour.(1) These factors are: (a) Bank size, (b) Bank growth rate, (c) Relative importance of time and saving deposits, and (d) Capital and reserves to deposits ratio. Relying on the multiple regression technique, Carson and Scott employed these factors (independent variables) to explain variation in bank liquidity (dependent variable) in the U.S.A.(2) The equation estimated was in a linear form. The theoretical treatment of the influence and direction of the relationship between liquidity and the above mentioned factors is shown for each factor as follows:(3)

(a) Bank Size. This variable has been frequently cited in the literature as having an important impact on liquidity behaviour.(4) On a priori grounds, the size of the bank should be inversely related to liquidity. That is, the bigger the bank, ceteris paribus, the less liquidity it can maintain. The explanation of such a relationship lies in the fact that since large banks can diversify their risk among a wide variety of portfolio selections, they are therefore more able to undertake riskier activities (thus maintaining less liquidity) as compared with smaller banks.(5) In

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(1) For the significance of the above four factors, see Deane Carson and Ira Scott, "Commercial Bank Attributes and Aversion to Risk", op.cit. PP.420-433; for the significance of Bank size, see also Ernst Baltensperger, "Economics of Scale, Firm Size and Concentration in Banking", Journal of Money, Credit and Banking (August 1972) PP.467-488; and Raymond McEvoy, "Variation in Bank Asset Portfolios", Journal of Finance, (December 1956) PP.463-473.

(2) Carson and Scott examined the influence of the above factors on variation in risk-aversion (i.e. liquidity preference) among commercial banks in the U.S.A. To indicate the degree of risk-aversion, many selected asset ratios (one of which the liquidity ratio) were used to serve as proxy variables. Relying on cross-section analysis including 3,930 banks, they found that the four factors were significant in determining bank liquidity with the correct hypothesized sign. These factors, however, were able to explain only less than half of the variation in the dependent variable. See Carson and Scott, op.cit.

(3) The following theoretical discussion is largely based on Carson's and Scott's.

(4) See Carson and Scott, P.422; McEvoy, P.473; and Baltensperger, P.484.

(5) Liquidity preference and risk-taking are used here as inverse terms.

other words, because of their ability to change the composition of their large asset portfolio by shifting from one asset to another when the need for liquidityarises, large banks are in a favourable situation to hold a lower proportion of their assets in a liquid form. Moreover, specialised resources and economies of scales associated with large banks, together with a relatively greater access to the money and capital markets, enable such banks to accept riskier business. Empirical studies showed some evidence for the existence of economies of scales in commercial banking. That is, the long-term average cost in banking industry declines as output increases.(1) Alhadeff and others emphasised the labour-intensive nature of the banking industry, indicating that specialisation of labour is the predominant determinant of any economies of scales.(2) As Alhadeff illustrates:

> ..."By virtue of the volume of business done in the different aspects of banking, large banks can afford to hire expert talent and to give its (sic) personnel in various fields an opportunity to specialise in their limited areas. Specialisation breeds expertise, and expertise enhances efficiency. In the banking functions of business lending and securities investment, the bankers in large institutions are probably more knowledgeable in their respective fields than their small-bank counterparts. In short, specialisation in large banks is conducive to greater efficiency of labour, and, ceteris paribus, to lower unit costs". (3)

Moreover, recent computerisation of bank operations has undoubtedly enabled the banks to get greater benefits of economies of scale..

Some interesting empirical work done by Baltensperger revealed that not only do banks' operational costs decline relatively with increasing size, but the large banks' reserves are also, on average, relatively

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(1) Output of commercial banks is defined as gross revenue or total assets, or aggregate deposits. See George Benston, "Economies of Scales of Financial Institutions", Journal of Money, Credit and Banking (May 1972) P.312.

(2) David A. Alhadeff, Monopoly and Competition in Banking (Berkeley: University of California Press, 1954) P.86; and Bell, F. and Murphy, N. "Economies of Scales and Division of Labour in Commercial Banking", The Southern Economic Journal (Oct. 1968) P.139.

(3) David Alhadeff, op.cit. P.86.

closer to the optimal level than the smaller banks'.(1) Another study conducted by McEvoy emphasised that bank size was (among other variables) a significant element in explaining variations in bank asset portfolio. He found that bank liquidity varies negatively and markedly with bank size.(2)

(b) Bank Growth Rate. This variable is expected to be negatively related to bank liquidity. That is, rapidly growing banks are expected to maintain less liquidity as compared with those which are experiencing slower growth. This may result from two situations. Firstly, bank management operational policies, whether aggressive or passive, are significant in determining the speed at which banks grow. One would expect a bank with aggressive management pursuing vigorous expansionary policies (either in competing for funds, or in exploring new investment outlets) to grow more rapidly than a bank with a passive management. Therefore, if a bank grows at a relatively fast rate because of aggressive operational policies, one would expect bank management to be also aggressive in selecting assets by increasing the element of risk, thereby minimising liquidity. Secondly, rapidly growing banks can maintain less liquidity because the growth process itself generates a continuous cash flow which reduces the need to operate at a high liquidity level.

(c) Deposit Structure.(3) Undoubtedly, the composition of bank deposits is one important factor in determining asset portfolio selection.

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(1) Ernst Baltensperger, op.cit. P.472.

(2) Raymond McEvoy, op.cit. P.473.

(3) The influence of this factor on liquidity behaviour is consistent with:
(a) Revell's concept of "Matching Maturities" as a general principle of balance sheet management. In determining liquidity holdings in the asset side of the balance sheet, a great emphasis should be placed on the nature and composition of liability structure of the financial institution concerned. See Jack Revell, The British Financial System, op.cit. PP.106-110.
(b) Richard Bond's argument which runs as follows: "The asset structure of a commercial bank is influenced to a considerable extent by its deposit structure. Time deposits, for example, tend to be more stable and predictable than demand deposits. As is well known, the greater stability of time deposits entices banks to place a greater proportion of these funds in high earnings, though less liquid assets". See Richard Bond, "Deposit Composition and Commercial Bank Earnings", op.cit.P.41.

Since term deposits are less fluid and volatile as compared with demand deposits, banks that hold higher proportions of their deposits in this form are more able to acquire risk assets. This accordingly implies that such banks can maintain less liquidity. It is therefore expected, on a priori grounds, that bank liquidity is inversely associated to the ratio of time and saving deposits to total deposits.

(d) Capital and Reserves/Deposit Ratio.(1) Theory does not clearly indicate the nature of the influence of this factor upon liquidity. The direction of the relationship between the two variables may be of either sign. That is, liquidity is either negatively or positively related to the ratio of capital and reserves to total deposits. The negative association between the two variables can be explained by the fact that, if one considers capital and reserves to serve on the liabilities side of a bank balance sheet as a substitute for liquidity on the asset side, banks with higher capital and reserves/deposit ratios can, ceteris paribus, operate with less liquidity. On the other hand, if capital and reserves were not viewed as above, one may expect the relationship to be positively related. The latter case can be explained by two possibilities: (1) This may be found in the case of banks with conservative dividend policies leading to the accumulation of capital and reserves at a rate higher than the growth of deposits. This is further encouraged by a conservative asset portfolio policy favouring excess liquidity. As Carson and Scott noted:

> ..."If conservative dividend policies are coupled with conservative portfolio policies, the previously expressed relationship between risk asset ratios (or as in our case liquidity ratio) and the capital-to-deposit ratio would be reversed."(2)

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(1) It is important to point out that capital and reserve accounts are subject to official regulations. As shown in Chapter 4, each commercial bank has to provide a minimum capital of JD 500,000. Moreover, bank regulations stipulated that every bank has to allocate 10% of its net profit for reserves up to a level when these reserves equal the value of bank capital. (Article 13 of the Temporary Banking Law of 1971). The purpose of capital and reserves regulations is usually to protect depositors from less of their deposits and to reduce the possibility of bank insolvency.

(2) Carson and Scott, op.cit. P.424.

(2) Or this may be the case in banks with aggressive management which tolerates both a low capital & reserves/deposit ratio and a tight liquidity position. In the latter case, banks' net worth (capital & reserves) increases at a rate slower than the growth of deposits. When this is accompanied by an aggressive asset portfolio management operating at a low level of liquidity, the influence of the relationship between the two ratios works in the same direction.

2. Liquidity Function Model.

Given the above theoretical framework, the liquidity function of commercial banks in Jordan may be postulated to be of the form:

$$L = a + b_1 S + b_2 G + b_3 T + b_4 K$$

where: L ≡ Liquidity
S ≡ Bank Size
G ≡ Bank Growth Rate
T ≡ Ratio of Time and Saving Deposits/Total Deposits
K ≡ Capital and Reserves/Total Deposits Ratio

and where: $b_1 < 0$, $b_2 < 0$, $b_3 < 0$

$b_4 \gtrless 0$

Using the multiple regression technique, the following analysis examines whether, and to what extent, the above liquidity function explains liquidity behaviour of commercial banks in Jordan.(1)

3. Data Used.

3.1 Structure of Data. For the purpose of the model, it was necessary to employ statistics pertaining to each individual bank's assets and liabilities. Since only the combined balance sheet of commercial banks is published by the CBJ, it was therefore necessary to obtain such information directly from the Banking Control Department of the CBJ, to which commercial banks are required to submit monthly statements of their balance sheets. All the ratios used in the model are based on individual

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(1) A correlation Matrix showed a weak relationship between the above independent variables, indicating small chances of multicollinearity.

banks' balance sheet reports as of December 31 of each year. The study covers the period 1967-1976 for which the required statistics were obtained. When the time series approach was used, the analysis was confined to the nine commercial banks for which statistics were available during this period. The remaining three banks, which were recently established, were excluded. However, statistics for the twelve commercial banks were employed when cross-section analysis was used.

3.2 The Nature of Variables. The variables used in the model have been calculated as follows -

A. The Dependent Variable (Liquidity Ratio). Ratios for individual banks' liquidity were readily obtained from the Banking Control Department. These ratios were calculated by this Department according to a certain formula relating short-term assets to total deposits and other short-term liabilities.

B. The Independent Variables.

B.1. Bank Size (S) was computed for each individual bank as a ratio of its assets to total bank assets (%).

B.2. Bank Growth Rate (G) was computed for each individual bank as an annual change in its assets over the preceding year (%).

B.3. Ratio of Time and Saving Deposits/Total Deposits (T) was computed for each bank individually (%).

B.4. Capital and Reserves/Deposit Ratio (K) was also computed for each bank individually (%).

4. Statistical Analysis (1).

Relying on a time series approach, equations were computed to relate liquidity for each individual bank to the explanatory variables discussed above. The results are given in Table 5.4 . As can be clearly seen, none of the explanatory variables were found to be statistically significant in influencing bank liquidity, except for one in the case of Bank I. The ratio of time and saving deposit/total deposits was significant and negatively associated with bank liquidity. This is consistent with the theoretical treatment of the relationship between

Table 5.4 Regressions of Changes in Selected Balance Sheet Ratios on Bank Liquidity For Individual Banks, 1967-1976.

DF = 5

| Bank | | Constant Term | Independent Variables | | | | $R^2$ |
|---|---|---|---|---|---|---|---|
| | | | S | G | T | K | |
| A | Reg.Coeff. | -12.700 | +1.871 | -0.784 | +0.518 | -1.601 | 0.295 |
| | T-Val. | | (0.223) | (0.669) | (0.222) | (0.254) | |
| B | Reg.Coeff. | -28.844 | +4.222 | +0.498 | +0.584 | +0.968 | 0.683 |
| | T-Val. | | (0.981) | (1.196) | (0.572) | (0.833) | |
| C | Reg.Coeff. | +54.799 | -6.122 | +0.425 | +0.793 | +0.437 | 0.396 |
| | T-Val. | | (0.973) | (1.588) | (0.814) | (0.416) | |
| D | Reg.Coeff. | +42.125 | -0.079 | +0.059 | +0.203 | -0.495 | 0.488 |
| | T-Val | | (0.203 | (0.281) | (1.067) | (1.019) | |
| E | Reg.Coeff. | +14.512 | +3.083 | -0.321 | +0.515 | +0.229 | 0.889 |
| | T-Val | | (0.643) | (1.445) | (1.751) | (0.499) | |
| F | Reg.Coeff. | +69.970 | +17.242 | +0.389 | -0.321 | -0.390 | 0.761 |
| | T-Val | | (1.780) | (2.123) | (0.397) | (1.169) | |
| G | Reg.Coeff. | +78.782 | -19.837 | +0.222 | +0.724 | +0.498 | 0.412 |
| | T-Val | | (0.351) | (1.495) | (1.137) | (0.536) | |
| H | Reg.Coeff. | +47.864 | -0.738 | -0.087 | -0.108 | -1.527 | 0.348 |
| | T-Val | | (0.274) | (0.141) | (0.097) | (0.555) | |
| I | Reg.Coeff. | +202.370 | +9.716 | -0.511 | -2.206 | -2.760 | 0.792 |
| | T-Val | | (1.313) | (1.715) | (2.464)* | (1.675) | |

* Significant at the 5 per cent level.

the two variables. However, the poor results obtained here may be largely related to the small number of observations (10 for each individual bank) which, for 5 variables, allow for only 5 degrees of freedom. This accordingly minimises the chances for the explanatory variables to record significant impacts on liquidity changes.

Therefore, attempts were made to employ the cross-section approach in order to explain the liquidity function of the commercial banks. It was expected that increasing the number of observations (though slightly) with the rise in the number of banks in recent years may improve the results. The regression equation for 1976 reads as follows:

(Year 1976)

$$L = 24.942 - \underset{(2.132)}{0.948S} + \underset{(2.035)}{0.414G} + \underset{(1.046)}{0.263T} + \underset{(1.288)}{0.663K}$$

$$R^2 = 0.661$$

$$DF = 7$$

None of the above independent variables were significant in determining bank liquidity. All the t-values of the coefficients were statistically insignificant.

Other attempts were also made to examine the liquidity function in other years but no tangible improvements occurred. When figures for 1975 and 1973, for example, were employed, the following equations were obtained with insignificant t-values of the coefficients for the all independent variables:

(Year 1973)

$$L = 57.689 - \underset{(1.654)}{1.348S} - \underset{(0.029)}{0.025G} + \underset{(0.258)}{0.102T} + \underset{(0.263)}{0.184K}$$

$$R^2 = 0.524$$

$$DF = 4$$

(Year 1975)

$$L = 38.118 - 0.439S - 0.061G + 0.167T + 1.311K$$
$$\qquad\qquad (0.620)\quad (0.944)\quad (0.430)\quad (2.067)$$

$$R^2 = 0.593$$

$$DF = 6$$

However, it is believed that the poor results obtained from using the time-series approach for individual banks and the cross-section analysis can be largely related to the small number of observations in each case which resulted in fewer degrees of freedom. It was frequently noticed that if the degrees of freedom were larger, some of the explanatory variables might have been significant in influencing liquidity behaviour. Therefore, it was found necessary to resort to an appropriate method which could increase the number of observations without affecting the structure and the assumptions of the model. The solution was found by pooling the data for the nine banks together for the ten years period covered by the study. In so doing, 90 observations were obtained. Such a procedure is justified since it does not influence the validity of the model. The model excluded time as an explanatory variable, and liquidity behaviour was assumed to be a function of certain balance sheet ratios. Pooling the data leaves these assumptions unaltered.

When regressing liquidity ratios on the same independent variables using the pooled data, some improvement occurred and the results are given in Table 5.5. This table is divided into three sections; the first showing the influence of each explanatory variable considered separately on liquidity change; the second shows the impact of the independent variables taken together; and the last part provides

Table 5.5 Regressions of Changes in Selected Balance Sheet Ratios on Bank Liquidity For All Commercial Banks, 1967-1976.

| | | Constant Term | Independent Variables | | | | $R^2$ |
|---|---|---|---|---|---|---|---|
| | | | S | G | T | K | |
| I | $R^2$ | | 0.272 | 0.003 | 0.002 | 0.353 | |
| One Independent Variable DF=88 | Const.term | | +64.911 | +53.485 | +49.576 | +36.792 | |
| | Reg.Coeff. | | -1.127 | -0.050 | +0.058 | +0.916 | |
| | T-Val | | (5.809)* | (0.514) | (0.469) | (6.925)* | |
| II(1) Independent Variables Together DF=85 | Reg.Coeff. T-Val | +42.808 | -0.626 (3.077)* | +0.112 (1.352) | +0.029 (0.294) | +0.759 (4.948)* | 0.440 |
| (2) DF=86 | Reg.Coeff. T-Val | +44.650 | -0.637 (3.201)* | +0.106 (1.329) | | 0.752 (4.982)* | 0.440 |
| (3) DF=86 | Reg.Coeff. T-Val | +48.522 | -0.674 (3.346)* | | -0.007 (0.070) | +0.683 (4.760)* | 0.428 |
| (4) DF=87 | Reg.Coeff. T-Val | +48.146 | -0.671 (3.391)* | | | +0.684 (4.796)* | 0.428 |
| III Jordanian Banks (5) DF=35 | Reg.Coeff. T-Val | +35.957 | -0.619 (3.412)* | -0.028 (0.174) | +0.701 (3.175)* | -0.463 (0.885) | 0.327 |
| Arab Banks (6) DF=25 | Reg.Coeff. T-Val | +70.835 | -8.980 (3.391)* | +0.146 (1.450) | +0.340 (1.533) | +0.036 (0.150) | 0.459 |
| Foreign Banks (7) DF=15 | Reg.Coeff. T-Val | 115.626 | -4.370 (4.849)* | +0.111 (0.424) | -0.274 (0.316) | -1.545 (1.021) | 0.729 |

* Significant at the 1 per cent level.

equations estimated for groups of banks classified according to nationality. Taken sepqrately, the test shows that onlytwo independent variables were significant in determining bank liquidity (Section I). The coefficients of Bank Size (S) and capital and reserves/deposit ratio(K) were found statistically significant at the 1% level with the coefficient signs' as hypothesized. Respectively, each variable was able to explain 27% and 35% of liquidity variation. Considering all independent variables together, only the above two variables exhibited a significant impact on liquidity with the correct signs. The coefficients for the other two variables (i.e. growth rate (G) and deposit mix (T)) were insignificant with opposite signs to those hypothesized (equation II.1). This means that the response of liquidity to the speed at which the bank grows, or the changes in the structure of its deposits was insignificant. Even when T was dropped from the equation, the remaining three variables explained the same percentage change in liquidity ($R^2$ remained the same at 0.440 as shown in equation II.2.), S and K were still significant whereas G remained insignificant. When the latter was excluded, $R^2$ dropped slightly to 0.428 with S and K remaining significant (equation II.3.). Excluding both G and T from the equation, $R^2$ remained at 0.428 with statistically significant t-values for the coefficients of S and K (equation II.4.).

These findings suggest that the size of the bank and the ratio of its capital and reserves/deposits were the dominant balance sheet factors determining bank liquidity. As regards bank size, the marginal response of liquidity to changes in size was negative and significant. The influence and the direction of the relationship are consistent with the theory discussed earlier, which related the inverse association between the two variables to economies of scales and portfolio diversification potentials of larger banks. As far as capital and reserves/deposit ratio was concerned, liquidity appeared to have a

positive and significant marginal response to a unit change in this ratio. As was theoretically discussed, the direction of the relationship may run both ways. The positive association between the two variables suggests the existence of banks with (1) either conservative dividend policies (accumulating bank net worth at a higher rate than the growth of deposits) coupled with conservative asset portfolio policies favouring excessive liquidity. (2) Or aggressive management accepting both a low capital and reserves/deposit ratio and a low liquidity ratio. As will be shown later, banks with both types of management led to associate L and K in a positive way.

Attempts were also made to examine the liquidity function for each group of banks classified according to nationality. Due to lesser degrees of freedom obtained in this case, one should take the results with some reservations. However, the impact of the independent variables on changes in liquidity for each group of banks was studied and the results are given in Section III of Table 5.5. The main findings were that:

(1) For all classes of banks, S was the dominant balance sheet factor influencing liquidity behaviour. This variable was statistically significant at the 1% level with the predicted negative sign.

(2) When commercial banks were divided into groups, K became no longer significant in determining liquidity.

(3) G continued to have insignificant impact.

(4) T remained insignificant for both the Arab and the foreign banks, whereas for the Jordanian banks the coefficient of this variable was statistically significant but with the opposite sign to that predicted.

The last finding pointed out the fact that while changes in the maturity structure of deposits did not seem to have a significant influence in determining liquidity for the Arab and foreign banks as groups, this variable showed significant impact on liquidity behaviour of Jordanian banks but in the reverse direction to that expected.

The opposite sign for the coefficient of the deposit mix in the Jordanian banks meant that the less risky the deposit structure, the more the need for liquidity. This is paradoxical in view of the theory discussed earlier, which emphasised that because of the more stable nature of time and saving deposits as compared with demand deposits, the need for liquidity is reduced as these deposits increased their relative importance in the deposit structure.

What seems remarkable from the equations pertaining to the three groups of banks is the large difference in the regression coefficients for size in each group. Size coefficients were, - 0.619, - 8.980, and - 4.370 for Jordanian, Arab and foreign banks respectively. These figures implied three distinctly different slopes. In other words, the marginal response of liquidity to a unit change in size in each group was very different, as indicated by the above values of the coefficients. It was shallower for Jordanian banks, steeper for the Arab banks and moderate for the foreign banks. Such differences may suggest that liquidity and size relationship are associated in a non-linear manner. Attempts were therefore made to introduce an element of non-linearity in the model and better results were obtained. This accordingly led to reformulation of the model as shown below:

5. Reformulation of the Model:

Attempts were made to express the previous relationship between liquidity and the four explanatory variables in the form of a quadratic function. The new model used is of the form:

$$L = a + (bS+CS^2) + (dG+eG^2) + (fT+gT^2) + (LK+iK^2)$$

The above quadratic equation means that the marginal effect of each independent variable on liquidity change is not measured only by the size of its coefficient ( as in the linear model) but it is also influenced by the level of the variable and the coefficient of its squared value.

6. Statistical Analysis (2):

Using the above quadratic model, only bank size and capital/deposits ratio appeared significant in determining liquidity behaviour. This is consistent with the results of the previous linear model. As is shown in the following equation, growth rate and deposit mix were insignificant:

$$L = \underset{}{54.628} - \underset{(4.283)^*}{3.071S} + \underset{(3.985)^*}{0.073S^2} + \underset{(0.544)}{0.051G} + \underset{(0.676)}{0.001G^2} - \underset{(0.741)}{0.501T} + \underset{(0.937)}{0.006T^2} + \underset{(4.123)^*}{1.974K} - \underset{(3.611)^*}{0.025K^2}$$

$$R^2 = 0.621$$

$$DF = 81$$

Dropping the growth rate and deposit mix from the equation, the liquidity function takes the following form:

$$L = \underset{}{56.865} - \underset{(5.428)^*}{3.525S} + \underset{(4.781)^*}{0.081S^2} + \underset{(4.103)^*}{1.500K} - \underset{(3.387)^*}{0.019K^2}$$

$$R^2 = 0.601$$

$$DF = 85$$

As compared with the previous linear model (equation II.4 Table 5.5), the above quadratic model improved the fit since (1) The independent variables explained higher percentage of liquidity variation. ($R^2$ became 0.601 as compared with 0.428 in the linear model). (2) The coefficients for S and K and also for their squared values were statistically significant at the 1% level. Due to the above, one can therefore say that the quadratic model is a better fit and the liquidity function of commercial banks in Jordan is quadratic in size and in capital & reserves/deposit ratio.

To illustrate this, however, the estimations in both the linear

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* Statistically significant at the 1% level.

and the quadratic forms are presented diagramatically and the observations are plotted in the diagrams. Since we have a three dimensional model, it was necessary to adjust the observations in order to plot them in two dimensional graphs showing the effect of each independent variable on liquidity. The procedures adopted were as follows:

Fitted plane is of form:

$$L = a + bS + cS^2 + dK + eK^2$$

In order to plot the L-S and L-K relations separately, we neglect the influence of one variable on liquidity when dealing with the other. In other words, we adjust the L value corresponding to the S (or K) to that which the model would predict if the K (or S) were zero. The estimated curves are:

(1) $K = 0 \qquad L_s = a + bS + cS^2$

(2) $S = 0 \qquad L_k = a + dK + eK^2$

Since actual observations never have zero S or K, we adjust observations to get rid of S (or K) as follows:

$$L_s = L - (dK + eK^2)$$

$$L_k = L - (bS + cS^2)$$

The estimated curves for $L_s$ and $L_k$ are shown separately in figures 5.3 and 5.4 respectively. Both figures illustrate that plotted observations are presented in a quadratic rather than in a linear form. As regards to liquidity - size relationship ($L_s$), the estimated quadratic fit shows that the initial effect of size on liquidity is negative up to a certain size level, then afterwards it becomes positive. As is shown in Figure 5.3, the marginal effect on liquidity of a unit change in size is negative up to size 22% (when the marginal response of liquidity is zero), then it takes a positive slope. The negative side of the relationship is consistent with the earlier theoretical treatment, emphasising economies of scale and asset diversification potentials

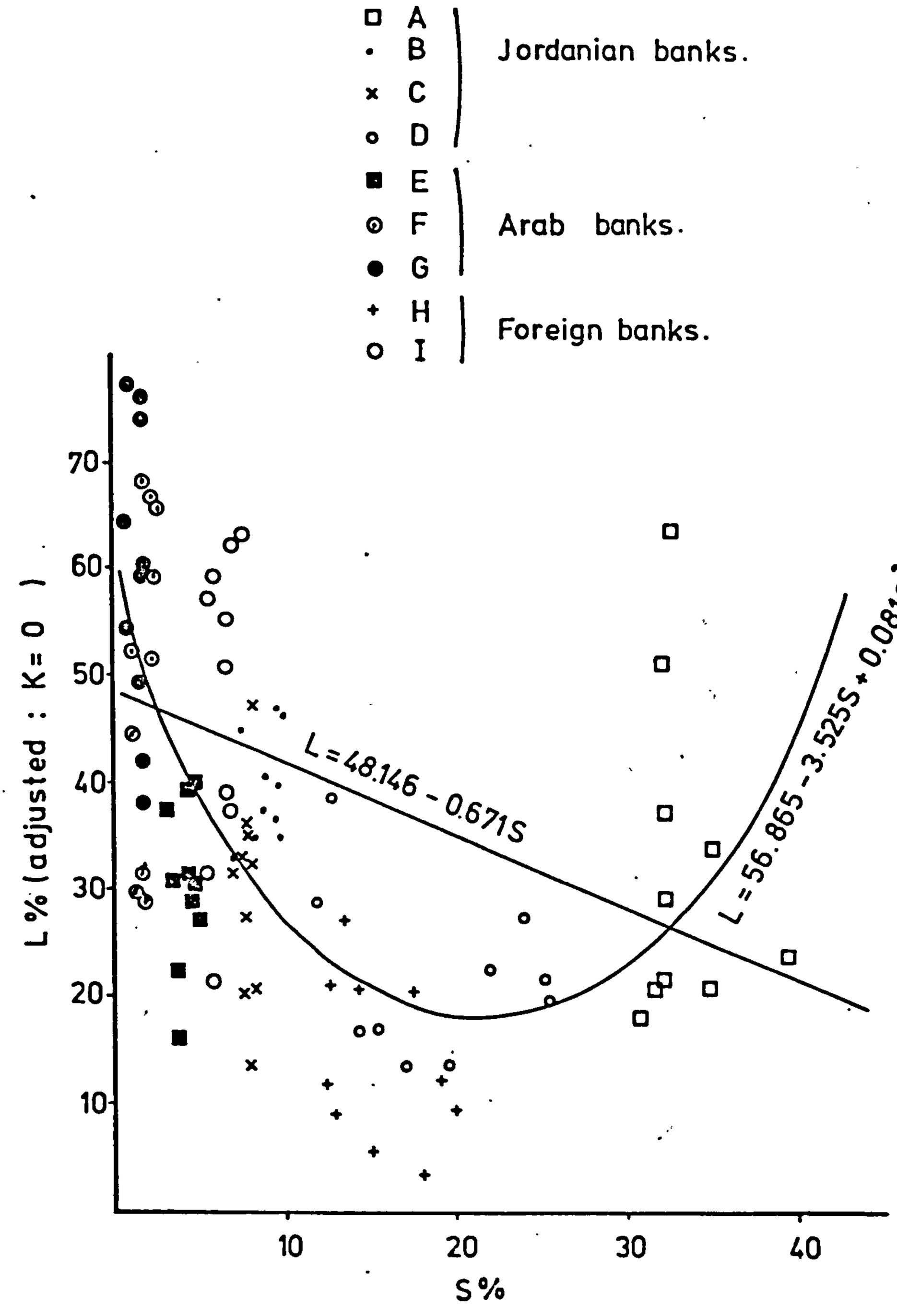


Fig. 5-3 Relationship between adjusted liquidity ( K=0 ) & bank size.
[K= capital / deposit ratio , L= liquidity ratio.]

associated with large banks, which accordingly enable them to operate at less liquidity as compared with smaller banks. What seems interesting and deserves explanation here is the positive marginal response of liquidity when bank size exceeds a certain level. This behaviour has two possible explanations:

(1) Economies of scale of large banks may turn to diseconomies of scale once bank size reaches a certain level. If this is the case, the adverse effects of diseconomies of scale ( which may result from a more sophisticated and bureaucratic control of bank management) can lead to less policy implementation, which is reflected in the overall efficiency of the bank. In such a situation, maintaining a high excessive liquidity can be considered as one aspect of the bank' declining operational efficiency.

(2) The positive liquidity-size relationship may result from the strange behaviour of some large banks which, irrespective of their size, maintain high liquidity. If this is the case, other factors which were not included in the model (such as the institutional factors) seemed to influence liquidity decisions of these banks, thus leading them to operate at a high excess liquidity, without being guided by liquidity-size criterion.

However, a close examination of Figure 5.3 will help to decide which of the above possibilities is likely to be the case. The figure clearly shows that the strange behaviour of one large bank (Bank A) seemed to influence liquidity-size relationship in the positive direction, since the rest of the plotted observations pertaining to the other banks fell within the declining side of the fitted curve. This means that the liquidity considerations of this large bank might be influenced by exogenous factors excluded from the model, rather than bank size. As mentioned at the outset of this chapter, bank liquidity can be largely influenced by institutional factors which were difficult to measure, such as bank management's attitude and propensity to avoid or accept

risk.(1) Judging by a close knowledge of liquidity behaviour of Bank A, one can say that due to very cautious and conservative policies adopted by its management, the Bank tended, on average, to operate at a high excess liquidity throughout the period under review. For this reason, a high level of liquidity was maintained irrespective of the large size of the Bank. Such a situation ultimately influenced the estimated liquidity-size curve to take a positive trend. If one overlooks the strange behaviour of this one bank, then banks in general behaved according to the theoretical treatment of the negative association between the two variables, as is illustrated by the figure. However, such an explanation of the positive side of the liquidity-size relationship seems more likely to be the case, especially if one takes into account the difficulty of finding any reasonable explanation of the first possibility, which related the positive response of liquidity to a unit change in size to diseconomies of scale. This is further supported by the absence of an appropriate theory associating diseconomies of scale to large banks.(2)

As far as the relationship between liquidity and capital & reserves/ deposit ratio was concerned ($L_k$), Figure 5.4 makes it clear that the estimated quadratic form is a better fit than the linear. The quadratic shape of the relationship means that the marginal response of L to a unit change in K is positive up to a certain point when K reaches 40% (where the marginal effect is zero) afterwhich the marginal response takes a reversed sign. This means that for banks with small values of K, the linear term (the positive sign) seems to dominate the relationship. As K increases, the second order term comes to dominate the relationship with a negative responsive sign. As was theoretically discussed, the association between L and K may take both signs, depending on how one

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(1) See P. 146

(2) As was discussed earlier, economic literature emphasised the existence of economies of scale in large banks. See PP. 163-165.

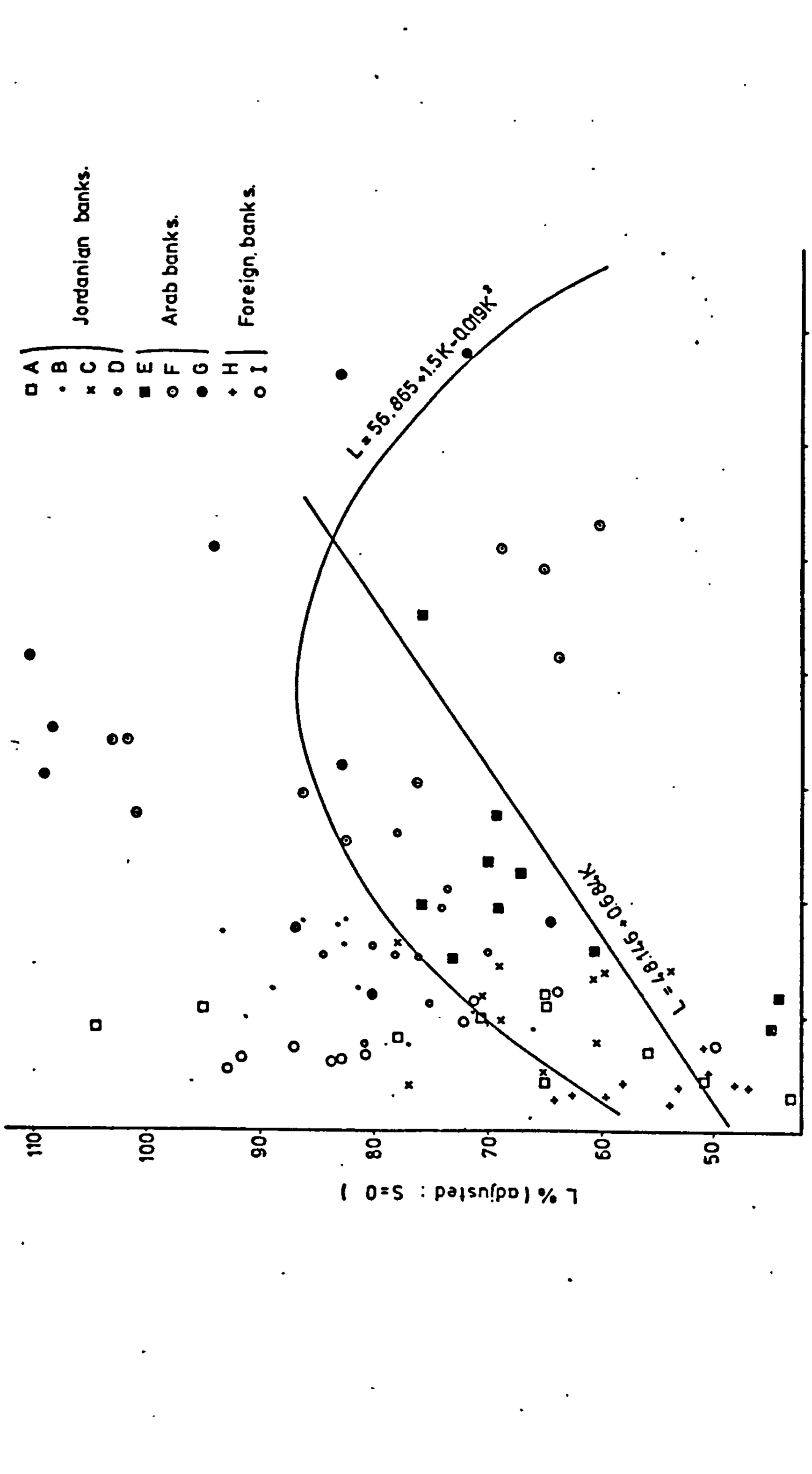


Fig.5-4 Relationship between adjusted liquidity ( S=0 ) & capital / deposit ratio.
[ K = capital / deposit ratio , L = liquidity ratio. ]

views K. If capital and reserves were considered on the liabilities side to serve as a substitute for liquidity on the assets side, L and K would be associated through an inverse relationship, showing that banks with higher K, ceteris paribus, can operate with less liquidity. The Jordanian experience showed that only in very few cases did banks consider their net worth as a substitute for liquidity. As can be seen from the Figure, only in rare cases[1] (when K exceeds 40%) some observations fall within the negative side of the fitted curve. The dominant case was that L and K were positively related, thus reflecting two possible behaviours which were both applicable to the Jordanian situation:-

Firstly, some banks followed conservative dividend policies leading to accumulate banks' net worth at a rate higher than the growth of deposits. This appeared to be the case in some banks, particularly one Arab bank owned by its government. In privately owned banks, dividend policies may be largely influenced by continuous pressures from share-holders, who are usually eager to increase dividends. This, however, may not be the case in governmental owned banks where the distribution of dividends, and even profit considerations, may not be of prime importance. In such cases, a bank net worth may increase at a higher rate as compared with the growth of deposits. This situation seemed to be accompanied by a conservative asset selection preferring investment in highly liquid forms. As a result, K and L moved in the same direction.

Secondly, other banks appeared to follow aggressive policies leading them to accept a low net worth to deposit ratio, and at the same time operate at a low liquidity level. Clearly, this also led to a positive relation between L and K. However, this seemed to be the

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(1) This comprises only 8 out of the 90 observations plotted in the Figure.

case in many banks which, due to the rapid increase in their deposits in recent years, experienced a declining ratio of net worth to deposits. This decline was, in fact, behind the CBJ's decision of 1975 to raise the minimum capital requirement for each bank from JD 250,000 to JD 500,000.(1)

Summary and Conclusions.

Attempts were made in the above analysis to relate liquidity to a selected set of balance sheet ratios, which may possibly explain liquidity behaviour. The influence of these ratios was examined with the aid of the multiple regression technique. The main findings of the analysis can be summarised as follows:-

1. The liquidity function was found to be quadratic in bank size and in the capital & reserves/deposit ratio. Both factors were statistically significant (at the 99 per cent level of confidence), explaining 60.1% of liquidity variation.

2. Bank size was the dominant balance sheet factor determining liquidity behaviour. Banks seemed to behave in accordance with the theoretical explanation of the liquidity-size relationship, which associated the two variables with a negative sign. This was the general case except for one large bank in which liquidity appeared to be influenced by other institutional factors (excluded from the model), rather than by the bank size criterion. The strange behaviour of this bank seemed to lead liquidity-size relationship to take a positive sign when bank size reached a certain level.

3. Capital & reserves/deposit ratio also had a significant impact upon liquidity. It was shown that the theoretical treatment of the influence of this variable is ambiguous. The direction of the relationship between the two variables may take both signs. The Jordanian

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(1) See Chapter 4, P. 95

experience revealed that most of the plotted observations fall on the positive side of the estimated quadratic fit. This meant that this factor was rarely considered by bankers as a substitute for liquidity on the asset side of the balance sheet (a case in which $L_k$ relationship would be negative). The dominant positive sign associating L and K was a reflection of the existence of both conservative as well as aggressive bank management in Jordan. In some banks, conservative dividend policies were accompanied by conservative asset portfolio policies, whereas in others, aggressive management policies prevailed in both sides of the balance sheet.

4. The remaining two factors, bank growth rate and the ratio of time and saving deposit/total deposits, were not significant in influencing liquidity behaviour. This finding was interesting particularly with regard to the deposit structure. Chapter 6 will now consider the policy implications of the above findings.

CHAPTER 6

# THE IMPLICATIONS OF EXCESSIVE LIQUIDITY HOLDINGS AND POLICY RECOMMENDATIONS

Three major conclusions emerge from the analysis of the previous chapter regarding the liquidity behaviour of the commercial banks in Jordan. These conclusions, together with the policy measures that are discussed later in this chapter, have been based upon (1) the preceding statistical examination of the influence of the balance sheet factors on bank liquidity behaviour, and (2) the personal interviews that the author conducted with the representatives of the commercial banks operating in Jordan during the summer of 1978 - Firstly, little attention has been given to the balance sheet factors in bank liquidity considerations.

Commercial banks in Jordan have not paid sufficient attention to the structure of their balance sheets when deciding upon their liquidity. This has been shown by the earlier statistical analysis, and has been further substantiated throughout the personal interviews with the senior managers of the commercial banks. The preceding statistical work revealed some irrational aspects of balance sheet management, particularly with regard to the insignificant impact of the maturity structure of deposits on liquidity behaviour. For all banks taken together, the general case was that the composition of deposits, whether on call or tied to certain periods, did not play an important role in determining asset portfolio selection. This was made worse in the case of the Jordanian banks (taken separately) whose liquidity showed a significant positive marginal response to a unit change in

the ratio of term deposit to total deposits. This was not only paradoxical in view of the earlier theoretical discussion, which negatively associated the two variables, but it was also against general principles of rational banking practice.

The personal interviews conducted with banks' representatives threw further light on the statistical results obtained earlier. Prior examinations of the balance sheet factors seemed to be of little significance in determining bank liquidity. It was understood that liquidity behaviour of commercial banks, in general, was mainly determined according to the demand made upon their credit, rather than balance sheet factors. The demand for bank credit (thus liquidity position) was largely influenced by prevailing as well as expected economic and political circumstances.

The insignificant role played by balance sheet factors can be partly attributed to the lack of academically qualified persons with adequate banking orientation among those who are responsible for general policy in many commercial banks. Bank policies (including liquidity considerations) are determined by the bank's board of directors. As a private shareholding company, the members of the board usually represent the major owners participating in the bank. Therefore, some members may assume their positions without being well qualified in banking. It was noticed that bank liquidity was largely influenced by the attitude of the bank's board of directors, especially the chairman's (i.e. whether it was conservative or aggressive, optimistic or pessimistic). This indicated the fact that liquidity behaviour of commercial banks, in general, was largely influenced by personal judgment and intuition, rather than being guided by rational balance sheet management.

<u>Secondly, excessive liquidity levels maintained by banks</u>.

Another major conclusion to be drawn from the preceding analysis

is that excessive liquidity holdings were not justified by the structure and the relationships between the main components of the bank balance sheet. Chapter 5 showed that these factors might have necessitated this behaviour. Some important balance sheet factors were found to be insignificant in determining liquidity. It can be, therefore, concluded that if banks took a full account of balance sheet factors, they would be able to operate with lower liquidity.(1)

The fact which clearly emerged from personal interviews was that the maintenance of excessive liquidity was largely due to conservatism and over-cautiousness on the part of many banks. Still influenced by their recent past when they used to operate under the colonial monetary system, some older banks continued to adhere to their orthodox lending policies and practice, which prevented them from venturing into innovative areas of activities.(2) As was shown in Chapter 2, operating at a noticeable high level of liquidity was one characteristic feature of colonial banking, which was largely the outcome of the very strict and cautious operational policies adopted by the banks. It was also noticed that banks' conservatism has been particularly encouraged by the prevelance of political instability in the region, particularly prior 1973,(3) which led many banks to pursue strict lending policies, thus further intensifying their liquidity preference. Moreover, these

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(1) The examination of the balance sheet ratios is not in fact enough for a close assessment of bank liquidity. This should not only be based on a bank's past record, as reflected in its balance sheet, but it should also consider the current and future flow of funds through the bank. This means to examine the cash flow forecast which reveals the extent to which the bank can meet all expected obligations within the due time. See Jack Revell, "The Solvency of Banks", The Banker, (Jan. 1975) P.28.

(2) This point is discussed later in this chapter, see P. 195

(3) For this impact on bank activities, see Chapter 2, P. 24

banks tended always to be very liquid in order to meet any sudden withdrawal of deposits that may result from such unstable conditions.

However, with the new operational circumstances, banks' behaviour and attitudes should correspondingly have changed. Over-cautiousness and excessive liquidity holdings might have been justified during the period of monetary dependence because:

i) There was no central bank which commercial banks could have resorted to in need of liquidity.

ii) Lack of domestic investment opportunities, especially in the absence of any national development programmes.

iii) Absolute freedom given to commercial banks to invest abroad, mainly in liquid forms.

iv) The highly volatile and unstable nature of government deposits held by commercial banks, which comprised an average of 36% of total deposits.(1)

Moreover, the argument that excessive liquidity holdings are justified by uncertainty and regional political instability does not seem to be a strong one. No bank, whatever its liquidity position, can escape financial embarrassment when such circumstances create nervousness among depositors, unless the central authorities interfere to regulate deposit withdrawal in order to protect the banks from the danger of a run on their deposits. This was what in fact happened in Jordan immediately after the 1967 War. In anticipation of substantial withdrawal of deposits, the CBJ restricted withdrawals by each customer from licensed banks to JD 100 per month.(2) In further support to banks' liquidity after this war, the government also decided to deposit with

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(1) J. Salah, The Evolution of the Banking System in Jordan, op.cit. P.42.

(2) This measure came into effect in the first day of the June War (the 5th) 1967, see CBJ, Fourth Annual Report, 1967, PP.35-36.

the banks amounts equal to a fixed proportion of their total fixed liabilities: Government's support to all banks amounted to JD 700,000.(1) Such measures were effective in preventing large withdrawals of deposits by their owners, who gradually resorted their confidence in the banking system.(2)

Thirdly, there are high social as well as private costs involved in excessive liquidity holdings.

Maintaining unnecessary excessive liquidity had undoubtedly significant repercussions on the overall performance of the economy, as well as on the banks themselves. The adverse effect of this behaviour can be illustrated in the following three major areas:

(a) A social opportunity cost was involved in adhering to this practice, in the sense of utilising unnecessary holdings of liquid assets for financing economic development projects.(3)

(b) Holdings of excessive liquidity minimised the effectiveness of domestic monetary management. Clearly, the effectiveness of a central bank's actions depends largely on the liquidity position of the commercial banks at the time when monetary policy measures are taken. Central banking experience in Jordan proves that the high level of commercial banks' liquidity worked to frustrate domestic monetary management, because these banks rarely resorted to the CBJ for liquidity purposes.(4)

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(1) This measure came into effect in the first day of the June War (the 5th) 1967, see CBJ, Fourth Annual Report, 1967, PP. 35-36.

(2) Private sector's deposits resumed growth in 1968 and 1969, after experiencing a decline in 1967. See Chapter 4, Table 4.2. P. 98

(3) This point will be further illustrated when discussing policy implications, see P. 194

(4) J. Salah, The Evolution of the Banking System in Jordan, op.cit. P.70.

This situation made it difficult for the CBJ to influence the volume of bank credit, as well as the money supply, by varying its own domestic assets. Thus, reducing the high liquidity level maintained by commercial banks was of paramount significance for the operational efficiency of domestic monetary policy.

(c) Operating at excessive levels of liquidity must have adversely influenced the profitability of the commercial banks. Undoubtedly, this practice involved a private opportunity cost in the sense of investing excessive liquidity in other competing less liquid assets, yielding higher rates of return. As is well known, banks usually consider the liquidity and safety of any operation on the one side, and its profitability on the other. Evaluating and weighing these factors is an inherently complex task. This is because assets carrying relatively high yields are generally less liquid and riskier than assets having low yields. As private business institutions, banks work to maximise their profits by holding assets in less liquid forms. However, the ability to invest in illiquid assets is largely restricted by the need to meet deposit withdrawals, which accordingly necessitates maintaining 'appropriate' levels of liquidity.(1) If banks increase their liquidity holdings above the level which can be deemed appropriate to meet liquidity requirements, the excess will be at the expense of their profitability. On the other hand, if banks undertake more aggressive investments by excessively increasing the proportion of illiquid assets

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(1) In fact, banks maintain a certain level of liquidity to meet other purposes, which are related to the existence of uncertainties. Moore revealed that the sources of uncertainties which banks possibly encounter are: The number of customers who might default, possible fluctuations in deposit liabilities, changes in the market value of securities held in asset portfolio, and adverse clearings. See Moore, Basil, J. An Introduction to the Theory of Finance: Asset-Holder Behaviour Under Uncertainty (New York: The Free Press, 1968) PP. 156-68.

in their portfolio, this might endanger their liquidity. Thus, the yield and liquidity implications of an asset management decision are perhaps the most important and most difficult problem facing bank management on a continuous basis.

However, both the previous analysis and the personal interviews supported the fact that the high level of liquidity maintained by commercial banks was unnecessarily excessive, which must have involved considerable opportunity costs. Some 'aggressive' banks believed that the high level of liquidity kept by other banks was much above the usual liquidity needs, which was a reflection of their conservative banking practice. Aggressive banks, in general, believed that operating at a level of liquidity just around the minimum level specified by the CBJ would be safe, and any holdings much above this level can be considered unnecessarily excessive,

A number of important policy measures arise from the above analysis, so that unless new operational and organisational procedures are evolved and implemented, both the technical efficiency of the commercial banks and their future contribution to domestic economic development will be impaired -

(1) The CBJ should ask the commercial banks to follow a more rational attitude to balance sheet management; particularly, due attention should be paid to the relationship between liquidity holdings and the maturity structure of deposits. Assets and liabilities should be closely matched by maturity. The insignificant impact of the deposit structure on liquidity holdings should further encourage the CBJ to ask commercial banks to extend their operations into longer-term activities. The earlier argument(1) of introducing the term lending technique into

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(1) See Chapter 4, PP. 129-133

Jordanian banking practice is further supported by the findings of this chapter. This innovation is not only necessitated by the significance of this type of lending to economic development needs, but, it is now further encouraged by holding a high relative weight of term deposits and, at the same time, maintaining excessive liquidity. It is believed that commercial banks could have been a potential source for longer-term lending, had they followed a proper matching between their assets and liabilities in this way.

(2) There is a need to establish, within each individual bank, a specialised research department comprising a well qualified and trained staff for the purpose of conducting research and studies pertaining to the main aspects of bank activities. Balance sheet management and the relationship between certain assets and liabilities are of special importance. Such studies can be accordingly forwarded to the board of directors for discussion and approval. In this way, the top decisions concerning the general policy of the bank (including liquidity considerations) will be established on a more academic and thoroughly studied basis.

The need to establish specialised departments for research work was, in fact, felt during the personal interviews; for example, some of the interviewed managers related the insignificant influence of the maturity structure of deposits on liquidity to the lack of sufficient flexibility within the bank's operational system, which was important for carrying out quick investment decisions. This was coupled with the absence of adequately prepared investment studies which could be readily available to absorb any additions to the bank's funds. An efficient bank should quickly manage to shift its resources to adequate channels and within the appropriate time. When the bank lacks flexibility and qualified specialists, part of its resources may remain idle or invested in readily liquid forms. For this reason, it might have often happened that a large proportion of saving and time

deposits had been invested in liquid assets, which were easily and quickly obtained. These term deposits were, in effect, employed as if they were demand deposits. Clearly, this situation not only diverted bank resources away from longer-term investments, but it also deprived the banks themselves of wider profitable opportunities had their assets appropriately matched the structure of their resources.

However, commercial banks may hesitate to create specialised departments for research work purposes, because of the long-term benefits associated with this specialisation, and because of the cost element involved. In reality, the cost would be greatly minimised if one considers the indirect benefits of the research work, which would be reflected on the overall efficiency of the bank. In fact, one big bank took the initiative by establishing a specialised research department for its own purposes.(1) Other commercial banks, even the small ones, should follow this example - this may not necessarily require the establishment of large departments with sophisticated techniques, but every bank has to tailor its own department to its particular needs. In this respect, the CBJ can be of a great help, given the long experience and qualified personnel of its research department.

(3) Commercial banks should direct their lending policies towards more innovative banking procedures. It was clear, particularly during the personal interviews, that many commercial banks were still adhering to orthodox lending practice, which was reflected in maintaining excessive liquidity. Their strict adherence to orthodoxy became increasingly irrelevant as shown earlier. Social as well as private opportunity costs implied by this behaviour were seen to be considerable. Banks should dynamically adjust themselves to their particular environment; they have to create new lending methods and techniques to suit their economy's changing conditions. Two areas of innovations

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(1) i.e. the Arab Bank.

are of particular relevance here:

(a) Part of the excessive liquidity holdings can be utilised for financing economic development projects through consortium activities with specialised credit institutions. As was frequently indicated, commercial banks usually prefer to invest their funds in highly liquid forms, and restrict their credit largely to short-term commercial activities. They are reluctant to finance economic development projects, mainly because of the high risk involved and the long-term nature of the credit required. The element of risk can be greatly reduced if these projects are sound and thoroughly studied. Commercial banks in Jordan are not in factequipped with adequate expertise in risk assessment. The proposed research departments may bridge this gap. Meanwhile, it is important for commercial banks to participate in economic development with the co-operation of the specialised credit institutions to finance joint development projects. This type of loan innovation appears to be both a promising and practical method. Specialised credit institutions have special systems for preparing projects' feasibility studies, and are also equiped with risk assessment expertise. Due to this reason, these institutions are able to select the economically viable and profitable projects. In this way, risk considerations can be largely minimised, and commercial banks can feel more secure about their future investments. Moreover, the financial requirements of the selected projects can be appropriately shared between the commercial banks and the specialised banks. The latter can provide the long-term needs and the required technical advice, whereas the former can meet the short and medium-term financial requirements. This will be a practical opportunity for the commercial banks to introduce the term lending technique (which has been frequently recommended) into their practice. Thus, participating with specialised credit institutions

in joint financing of development projects will absorb part of banks' excessive liquidity. This will consequently reduce both the social as well as the private costs involved in maintaining this practice.

Government backing of the selected projects can further encourage commercial banks to undertake this type of business.(1) Some interviewed senior bankers emphasised that this will be important to give more confidence to the commercial banks and encourage them to finance developmental activities. However, the Government is already backing some big industrial enterprises, and it will be socially beneficial to extend its backing to cover those projects which can form successful consortiums.

(b) 'Conservative' banks, in particular, are required to abandon their strict adherence to 'armchair' banking and move towards dynamic banking, by marketing their services and exploring domestic investment opportunities. One main difference between a 'conservative' banker and an 'aggressive' one is that the former is an armchair banker who passively awaits for the appropriate business to come to him. An aggressive banker, in contrast, actively seeks business and is not conventionally restricted by certain types of business or collateral.(2) The latter is more dynamic and innovative, and thus more suitable to the changing nature of the developing economy. It was shown that both types of managements existed in commercial banking in Jordan. The conservative banks still

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(1) Government backing may take the form of participating in the share capital or guaranteeing the success of the project by, for example, securing the distribution of an annual minimum rate of net profits to the shareholders.

(2) For a further differentiation between orthodoxy and unorthodoxy in banking practice and the unsuitability of the former, see G. Nwankwo, "Traditional Banking in Developing Countries," The Bankers' Magazine, (Feb. 1973) PP. 65-68.

strictly adhered to an orthodox lending practice of armchair banking. They never ventured to look for business or explored new investment opportunities. Unorthodox banks also existed with aggressive lending policies, venturing beyond the traditional banking practice. They were not satisfied by waiting for business to come to them asking for finance, but they also went out searching for new business and acquainting customers with their services.

However, the competition between the above two types of banks prior to 1973 was not active, and each one had its own share in the market. The recent increase in the number of commercial banks and the keen competition that followed made it difficult for the conservative banks to maintain their previous level of business, whilst adhering to their strict orthodoxy.(1) Active competition in the credit market, resulting from aggressive policies approaching borrowers with competitive offers, led to a noticeable transfer of customers away from the conservative banks. As a result, a large proportion of conservative banks' funds were kept idle, thus further increasing their excessive liquidity holdings. A senior conservative bank manager related the increase in excessive liquidity holdings of his bank to the lack of available avenues for domestic investment, resulting mainly from the recent competition between banks. However, it is believed that it was the lack of adaptation on the part of many banks rather than the shortage of domestic investment opportunities that led these banks

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(1) For competition in domestic banking, see chapter 5, PP. 155-161

to maintain excessive liquidity. This belief was supported during an interview with another conservative bank manager, who emphasised that if his bank does not change its conventional credit policy to face the new competitive market, there will be a gradual loss in customers and a continuous rise in liquidity. The above belief can be also proved by the steady rise in the demand for bank credit extended by the aggressive banks. An interview with an aggressive bank's manager revealed that the demand for credit made upon its bank was more than to be met by the current capacity of the bank. This led the bank to borrow from another conservative bank, with excessive liquidity holdings, at a rate of 6%, and then relent to the public at 9%. This was in fact a clear example of the availability of domestic investment opportunities, which were greatly increased since the launching of economic development programmes in 1973. Conservative banks are, therefore, required to move towards innovative lendingpractices by marketing their services and approaching the borrowers with attractive offers. They should go out to business and explore new investment channels for investing their excessive liquidity. Their armchair banking would be better replaced by dynamic and innovative banking. However, such changes require comprehensive studies of the market conditions, which the previously proposed research departments can adequately provide.

(4) There is a need to develop an active money market and encourage inter-bank borrowing, which may reduce excessive liquidity holdings. It was shown in Chapter 4 that commercial banks, particularly American ones, began to shift their emphasis towards the liabilities side of their balance sheet as a major source of liquidity. This was illustrated by the 'liability management' theory that emerged in the 1960's.(1) Banks realised that they could secure their liquidity

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(1) See Chapter 4, P.124

best, not only by holding liquid assets in their portfolios, but also by resorting to the money market for additional funds. The reliance on the liabilities side of the balance sheet was greatly facilitated by the existence of active money markets, through which banks were able to raise funds by offering attractive yields on the borrowed funds, and by issuing new types of deposits, such as certificates of deposits. Therefore, promoting such a market in Jordan will make it easier for the commercial banks to operate at a comparatively lower liquidity, because they can quickly meet their needs of funds through the market. It was understood throughout the personal interviews that due to the absence of this market, commercial banks sometimes maintained liquidity above the level which was required to meet current needs. For example, it often happened that banks kept part of their funds in a highly liquid form in order to redeem a future liability maturing in one or two weeks time. If an active money market was available, these funds which were kept idle (or invested in low yield forms) would be employed somewhere else, and the need for liquidity could be met through the market at the time when the liability matured. Clearly, this situation must have had some opportunity costs since these funds (which were tied up liquid for a certain period) could be invested in other alternative assets yielding higher rates of return.

(5) Maintaining excessive liquidity in commercial banking further requires the monetary authorities to adopt a positive and more realistic interest rates policy. It was shown in Chapter 3 that due to the adverse effects of pursuing a traditional low interest rate policy (in particular its impact in reducing the real yield on financial savings to negative values), the CBJ was asked to raise domestic interest rates to realistic levels. The full argument for introducing such a change is dealt with in Chapter 11. What is necessary to point

out here is that the above argument is further supported by the need to reduce excessive liquidity holdings of the commercial banks. Liquidity preference on the part of the banks, in general, must have been intensified by the prevailing low real loan rates. Effective low real rates on bank credit have undoubtedly discouraged commercial banks to venture beyond the traditional lines of business, thus restricting their credit to well-established borrowers. A low real maximum ceiling on loans rate was not sufficient to cover the usual administrative costs and the potential default risks involved in new lines of business, particularly those connected with development programmes. This accordingly encouraged conservatism and led to maintaining excessive liquidity in domestic banking. Prominent monetary economists observed the above effect in many developing countries, that are traditionally adhering to effective low real interest rates policies. McKinnon states that:

> "In addition to restricting the overall volume of bank lending, the interest ceiling ensures that the trickle of available finance flows to completely safe borrowers whose reputation is known or whose collateral is relatively riskless. Or worse, the great excess demand for loans allows allocations to be contingent on political or 'establishment' connections. Importers holding exclusive licences, or the largest landowners, or various government agencies are likely to be the beneficiaries."(1)

Shaw also emphasises that "Effective low ceilings on real loan rates intensify risk aversion and liquidity preference on the part of intermediaries. Banks and others keep a privileged place in their portfolios to established borrowers, especially trading firms with a long record of stability. They have little incentive to explore new and less certain lending opportunities."(2)

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(1) Ronald McKinnon, Money and Capital in Economic Development, op.cit. P.73.

(2) Edward Shaw, Financial Deepening in Economic Development, op.cit. P.86.

(6) Finally, the CBJ may work to reduce bank liquidity by the introduction of a special deposit scheme, so that any bank which maintains liquidity above a minimum required level has to deposit a specified proportion of the excess liquidity in the form of a special deposit with the CBJ. These deposits can be used by the latter, either for re-lending to the specialised credit institutions, or utilised directly for financing productive projects with close connections to development programmes.(1)

Prior to a reassessment of these innovations in the content of a consideration of the role of the central bank (Chapter 11), the remaining parts of the financial system (i.e. the non-bank sector) need to be outlined and analysed.

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(1) Such innovations will be discussed in detail in Chapter 11. See PP. 372-378.

PART C

# THE NON-BANK FINANCIAL INSTITUTIONS

CHAPTER 7

# THEORETICAL CONSIDERATIONS CONCERNING THE EVOLUTION AND SIGNIFICANCE OF THE NON-BANK FINANCIAL SECTOR IN ECONOMIC DEVELOPMENT

## (I) NON-BANK FINANCIAL INTERMEDIARIES AND THE EFFECTIVENESS OF MONETARY POLICY.

The rapid growth of non-bank financial intermediaries (NBFIs) in developed countries raises controversial issues regarding the influence of these institutions on the effectiveness of monetary policy.(1)

The increasing importance of NBFIs in the financial system is seen by many as a potential threat to monetary stability, thus requiring the monetary authorities to exercise some degree of control over their activities. This view emerged in the U.S.A. in the early 1950's, mainly as a result of the important theoretical work of Gurley and Shaw.(2) A similar study, the 1959 Radcliffe Committee's Report on the Working of the U.K. Monetary System, called attention to the threat posed by the existence of a large supply of near-money assets held by NBFIs when monetary control was confined only to the control of the

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(1) The controversy rose as whether to consider NBFIs as similar to commercial banks (thus subjecting them to administrative monetary control), or as different financial intermediaries (thus excluding them from central control). In general, the controversy took three main aspects. Firstly, the distinction between the two types of intermediaries was made on the ground that only the liabilities of the commercial banks are widely used as a medium of exchange. Secondly, whether the activities of NBFIs affect the general liquidity position of the economy. Finally, whether these institutions act as loanable funds brokers just operating as clearing stations for ex-ante savings on their way to borrowers, or they can create loanable funds by their own operations, like the commercial banks. For a full review of the controversy and the related references, See: G. Clayton, "British Financial Intermediaries In Theory and Practice" Economic Journal, (Dec., 1962) PP.869-886.

(2) See: J. Gurley and E. Shaw, "Financial Aspects of Economic Development" American Economic Review, (Sept., 1955) PP.515-538.

liquid assets held by the commercial banks.(1)

In developing countries, however, NBFIs are still at an early stage of development, constituting only a small part of the financial system. Institutions specialising on either the mobilisation of resources, or the disposition of such funds between different outlets, are noticeably limited. Commercial banks are still by and large the predominant element in the financial system. Thus, much of the controversy regarding the impact of the NBFIs on the effectiveness of domestic monetary management is irrelevant to most developing countries. Jordan is a case in point. The size of NBFIs is still relatively small as compared with the commercial banks. Highly developed specialised institutions similar to those available in developed countries, such as finance houses, investment trust companies, unit trusts, and specialised investment agencies are still non-existent. Moreover, in spite of some diversification in the financial system in recent years, the majority of NBFIs is concentrated on the credit side as represented by the specialised credit institutions. Apart from the Housing Bank (established 1974) which has been active in mobilising funds in addition to its role in extending housing credit, none of the specialised credit institutions shows any interest in attracting domestic savings. In contrast to commercial banks, therefore, the liabilities of these institutions are not used as a medium of exchange. For this reason, together with the small relative size of NBFIs, it can be concluded that the existence and operations of such institutions have not in fact significantly impaired the effectiveness of monetary management in Jordan. However, it will be shown that because of its mobilisation activity, the rising importance of the operations of the Housing Bank must have left some influence on the general liquidity position of the

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(1) G. Clayton, "British Financial Intermediaries In Theory and Practice", op.cit. P.87.

economy. This situation requires the monetary authorities to subject this particular specialised institution to some kind of control in order to prevent any frustration of domestic monetary management policies.

One of the other problems that can exist in developing countries is the unofficial intermediary role performed by money changers that sometimes may be important, especially where there is a trade bias to the development of the economy. In Jordan, for example, money changers (Sarraffeen) are permitted to undertake direct dealings in foreign exchange and local currency, but there are no official statistics that reveal the magnitude of their operations. This market operated together, and in competition, with the official money market to finance foreign trade transactions. Despite many attempts made by the Central Bank of Jordan to regulate and influence their operations, the Sarraffeen continued to be out of any effective central control.(1) The problem, on the one hand, is that this unofficial market positively adds to the mobilisation and activation of monetary funds,but, on the other hand, if these activities are not effectively regulated, the efficiency of any national monetary policy pursued may be partially impaired. In developed countries, these activities are usually institutionalised and make subject to central bank regulation.

## (II) THE EVOLUTIONARY PATTERN OF THE NON-BANK FINANCIAL INSTITUTIONS IN DEVELOPING COUNTRIES AS COMPARED TO DEVELOPED COUNTRIES.

In developed countries in general, NBFIs have gradually evolved in response to the normal processes of market pressure.(2) Apart from

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(1) This area is beyond the scope of this thesis. For some further details, See Fariz, Z., The Role of Foreign Trade in the Economic Development of Jordan, (U.K. : Keele University, Ph.D. Thesis, 1978) PP.226-228

(2) E. Nevin, Capital Funds in Underdeveloped Countries, op.cit. P.73.

a few cases where official intervention resulted in the establishment of specialised institutions to fill certain gaps in the credit structure, in general, the financial system expanded and diversified in accordance with the increasing demand made upon its services. Private profit considerations were almost sufficient to induce further financial specialisation and diversification, thus leading the financial system to take a 'demand-following' pattern of evolution.(1) Government financial agencies, where they existed, played only a marginal and supplementing role as compared with the part played by the privately owned institutions.(2) However, this was not the case in developing countries in which NBFIs were 'supply-leading' rather than 'demand-following' institutions. In general, NBFIs were established in advance of the demand made upon their services. In these countries, profit expectations were highly uncertain and unable to attract sufficient funds to be invested in some important sectors (such as agriculture and manufacturing) which were still at a rudimentary stage of development. Thus, private institutions for financing such activities were not likely to evolve through the free forces of the market, which accordingly necessitated official intervention by deliberately creating such specialised institutions.

## (III) THE NEED FOR DELIBERATE CREATION OF THE NON-BANK FINANCIAL SECTOR IN DEVELOPING COUNTRIES.

The failure of the free forces of the market mechanism to develop

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(1) For the evolutionary patterns of financial institutions, see Chapter 1, PP.8-9

(2) E. Nevin, op.cit. P.74.

an adequate network of NBFIs resulted in creating certain financial gaps in the financial structure, which seriously hindered the growth of developing economies. To achieve the set development objectives, development planners in these countries emphasised the necessity of bridging such gaps by deliberately creating specialised financial agencies to perform specific important functions. The development of some basic sectors, such as agriculture, manufacturing, and housing has been given special attention in most developing countries within comprehensive development programmes. These sectors, however, suffered from a lack of adequate finance necessary for their development. Commercial banks were generally reluctant to finance these sectors, mainly because of the long-term nature of the credit required, and because of the high risk involved in financing such activities. Their reluctance was further accentuated by their strict adherence to orthodox banking practice which restricted their lending to short-term, self-liquidating transactions available in the foreign trade sector. Given the significance attached to these sectors in national development plans, it was therefore highly costly for developing countries to wait without bridging such a gap in the financial system. This task has been shouldered by the central banks in these countries, where the prevalence of underdeveloped financial infrastructure necessitated a larger developmental role of monetary policy. Central banks in today's developing countries are not only concerned with pursuing selective credit policy aiming at influencing the allocation of bank credit in favour of development, but they are equally interested in setting-up an adequate network of specialised institutions to fill certain gaps. It is recognised that even in developed countries the approach of "institution-related" is more useful and effective than the "market-related" approach in directing the allocation of financial

resources towards developmental activities.(1) Since commercial banks are private profit maximisation institutions, their operations may not coincide with social costs and benefits if they are left to function in accordance with the free forces of the market. Reliance on market allocation of bank resources is socially more harmful in developing countries, where the possible divergence between private and social costs and benefits is greater than in developed countries. However, due to the large size and the risky nature of the credit gaps in these countries as shown above, the "institution-related" approach of monetary policy there should not only be confined to encouraging the flow of bank credit to priority sectors, but it should be also extended to "institution-creating" approach by setting-up necessary non-bank financial intermediaries.

The creation of specialised credit institutions was not only necessitated by a lack of finance in certain industrial sectors, but it was also encouraged by the absence of adequate finance in specific sections within the same industry. General experience in most countries shows that small and medium-sized industries, and some new concerns in particular industries, often encountered difficulties in obtaining sufficient finance.(2) Private financial institutions were so reluctant to finance such businesses because of the administrative expense and high default-probability involved.(3) This accordingly led to the creation of government specialised agencies capable of providing these sectors with adequate assistance. Similar gaps in the capital market also

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(1) Morison, I. and Brown, R., "Monetary and Credit Controls in the U.K.", The Banker (August: 1975) P. 879.

(2) Gupta, L., The Changing Structure of Industrial Finance in India; The Impact of Institutional Finance (Oxford, Clarendon, 1969) P.86.

(3) E. Nevin, op.cit. P.84.

existed in the more developed countries, such as the U.K., where the experience revealed the existence of what was called "The Macmillan Gap". Established upon government request, the Macmillan Committee pointed out the great difficulty encountered by the smaller and medium-sized firms in raising capital. The investigations of the Committee and the recommendations that followed led to the formation of special institutions for financing such concerns.(1)

In addition to specialised credit institutions, government intervention in developing countries was also extended to the rest of the non-bank financial sector, by setting-up other institutions with different financial specialisation, such as stock exchange markets, pension funds, postal savings banks, and other investment corporations. The creation of these specialised institutions was deemed, by development planners, as necessary channels for effective mobilisation of national savings and their productive utilisation in long-term domestic investments. By so doing, such institutions were expected to perform an important role in facilitating and achieving the set development goals. As will be shown later, development planners in Jordan rightly placed great emphasis on the non-bank financial sector as an essential instrument for achieving the country's development objectives. The establishment of this sector and its activities were largely assisted and promoted by successive development programmes, and by government legislation and other fiscal incentives.

## (IV) CHARACTERISTICS AND FUNCTIONS OF SPECIALISED CREDIT INSTITUTIONS IN CONTRAST TO COMMERCIAL BANKS.

Specialised credit institutions are closely related to development

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(1) Raymond Frost, "The Macmillan Gap, 1931-53", Oxford Economic Papers (1954) PP.181-201.

finance and this is why they are sometimes referred to in the literature as "development banks". One distinguishing difference between these banks and the ordinary commercial banks is that while the activities of the latter are completely guided by profit considerations, the criteria adopted by the former in selecting projects for assistance place particular emphasis on the economic priority of the project and its significance for economic development.(1) Development banks are characterised by combining both banking and developmental criteria when taking investment decisions.(2) As banks, they are concerned with the profitability of their investments as can be judged by examining the financial position of the enterprise concerned, its capital structure, the value and quality of assets provided as collaterals, etc. As development agencies, at the same time, they are interested in the national priority of the selected enterprise and its overall impact on promoting economic development. This dual nature of development banks makes their role of particular importance from the standpoint of economic development. This is because not all "bankable" projects are necessarily important for economic development, nor is every economically essential project necessarily "bankable".(3) There are many projects which may satisfy only one of the above attributes, thus creating some difficulties for development bankers when taking

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(1) Gupta, op.cit. P.102.

(2) For more details of the banking and development functions of development banks, see: Boskey, S., Problems and Practices of Development Banks (Baltimore,1959) PP. 49-55; Basu, S., Theory and Practice of Development Banking (New York:Asian Publishing House, 1965) P.51; and Houk, J., Financing and Problems of Development Banking (New York:Frederick Praeger, 1967) P.2.

(3) Boskey, op.cit. P.50.

investment decisions. Such a situation becomes more difficult if a proposed project is expected to produce general benefits for the economy (such as increasing employment opportunities and improving the balance of payments' position) without direct benefits being accrued to the enterprise itself. However, as is generally observed, development banks cannot achieve their developmentalobjectives if they largely confine themselves to "bankable" projects; at the same time, they cannot frequently overlook the profitability of their investments which may endanger their financial position.(1) A development banker should carefully consider both aspects of development banking.

The above characteristics of development banks are reflected in their particular functions which differentiate them from the ordinary commercial banks. From a functional point of view, a development bank is distinguished from a commercial bank if it is designed to perform banking and promotional functions.(2) Moreover, the nature of the banking function in both types of intermediaries is clearly different. The banking function of development banks covers areas that commercial banks do not usually undertake. While the commercial banks restrict themselves mainly to financing short-term transactions, the principal financial function of the development banks is the provision of medium and long-term capital. Development banks can also perform their role as a channel for long-term finance through direct equity participation in domestic enterprises, or by guaranteeing loans obtained by these enterprises from other sources. Furthermore,

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(1) Boskey, P.50, and Basu, P.51.

(2) Houk, p.2

by underwriting attempts of borrowers to raise equity or debt, these banks can generate public confidence in domestic industries, thus stimulating the flow of private savings towards long-term financial instruments.(1) Clearly, such functional aspects of development banking have special implications for promoting domestic capital markets.

In addition to the above financial functions, a development bank has also a promotional role as a major source of technical assistance, which is necessary for encouraging domestic entrepreneurship. This aspect of development banking has a special significance in developing countries, which largely suffer from a lack of comprehensive investment surveys, and the absence of dynamic entrepreneurs with business attitudes towards operations in new fields of investment.(2) Development banks can help to minimise these difficulties by providing managerial guidance and technical advice, on the one hand, and by initiating feasibility studies and pre-investment surveys in various sectors of the economy on the other. By exploring and identifying viable domestic investment avenues, indigenous businessmen will be encouraged to take advantage of the new investment opportunities so highlighted. Development banks can thereby greatly assist and hasten the development process.

Given this theoretical framework, the three chapters that follow examine how, and to what extent, the non-bank financial intermediaries contributed to Jordanian economic development. In particular, attention will be given to considering the following 5 main questions -

(1) Were these institutions 'demand-following' or 'supply-leading' institutions, and how did the type of evolution influence the development process?

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(1) Furness, E., Money and Credit In Developing Africa, op.cit. P.34.

(2) Houk op.cit. PP. 3-4.

(2) What were the roles given by development plans to the non-bank financial institutions? Were these assigned roles realistic or merely ambitious? To what extent were these institutions able to perform their planned role?

(3) What was the nature of the financial gap which necessitated the creation of each specialised institution, and was their establishment really justified by the actual needs of the economy?

(4) Did specialised credit institutions operate properly within a development banking context as has been theoretically discussed? Were their operations consistent with the development strategy as envisaged by economic development plans? What operational criteria were adopted by these institutions as distinct from ordinary commercial banks, and did such criteria directly promote growth?

(5) Finally, has the creation of the non-bank financial sector adequately filled the previous gaps in the financial system; and if not, how can this be better achieved?

These questions will be considered firstly in the case of the specialised credit institutions (Chapter 8) and subsequently the contractual financial institutions and Postal Saving Fund (Chapter 9) and thereafter the Amman Financial Market (Chapter 10).

## Chapter 8

### THE SPECIALISED CREDIT INSTITUTIONS

Specialised credit activity is a post-independence phenomenon in Jordan. During the colonial period, there was a distinctive gap in the financial structure represented by the absence of specialised credit institutions (SCIs) to finance the needs of specific important sectors of the economy, which were inadequately served by commercial banks. Due to its straight-jacket style of monetary control, the Currency Board System was neither able to correct the existing bias in bank credit towards the foreign trade sector, nor to develop an effecitve specialised credit mechanism to assist and promote the development of these sectors. Since the monetary authorities continued to pursue substantially the same type of monetary policy throughout the first 14 years of political independence, the above-mentioned credit gap remained essentially unchanged, depsite the establishment of the Municipal and Village Loans Fund (1957) and the Agricultural Credit Corporation (1959). Diversification of the financial institutional infra-structure had to await the setting-up of the CBJ in 1964, and the concomitant launching of the 7 Year Development Plan (1964-1970), the development goals of which required such changes if they were to be achieved. The Plan remarked on the unsatisfactory developmental role played by the financial institutions in the past, and emphasised the need for greater future participation of these institutions if the planned rate of economic growth was to be achieved.(1) To that end, the newly established Central Bank was given larger responsibilities and greater powers than itspredecessor(the Jordan Currency Board) to

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(1) Jordan Development Board, 7 Year Plan for Economic Development, op. cit. P.336

facilitate and assist the implementation of this programme, by organising and adapting the country's financial structure to fit domestic development needs.(1) In particular, certain key sectors were singled out as requiring institutional attention, being seriously inhibited by a shortage of private capital and entrepreneurial talent - these were: agriculture, manufacturing, housing, and mimicipal and rural affairs.(2) The Plan realised that credit-supplying agencies were not only important to provide direct financial and entrepreneurial assistance, but it was also essential to create the public confidence in these sectors, thus attracting further private investments.(3)

The development of SCIs was further encouraged by the 3 Year Plan of 1973 and the 5 Year Plan of 1976. In recognition of the significance of the above mentioned sectors in achieving overall development objectives on the one hand, and the continued inadequacy of capital and entrepreneurial guidance available in such sectors on the other, both plans demanded a strengthening of the network of SCIs, either by assisting the already established institutions or by creating new ones with sufficient resources and adequate expertise.(4) Moreover, the two plans went further in pointing out that some operational deficiencies existed in these institutions, thus requiring them to adapt their policies and techniques in accordance with domestic development requirements. However, the extent to which the government responded to the plans' recommendations regarding the setting-up of SCIs, and the extent

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(1) Ibid. P. 338

(2) Ibid. P. 209 and 341

(3) Ibid. P. 209

(4) National Planning Council, Three Year Development Plan, op. cit. (P.60) and the Five Year Plan, op. cit. (PP.68-72)

to which the latter succeeded in performing their assumed developmental role will be revealed throughout this chapter.

Undoubtedly, the official interest and encouragement given to SCIs led to a noticeable increase in the number of these institutions and in their activities. This is clearly indicated by Table 8.1 which shows that by 1977, there were six credit institutions specialising in financing and promoting the key sectors of the economy. A clear indication of the growth of these institutions is provided by statistics of the volume of their credit. This rose from only JD 12.08 million in 1967 to JD 80.14 million in 1977.(1) Most of this increase occurred after 1974 due, firstly, to the general rise in the activities of all institutions resulting from launching development programmes, and secondly, because of the entry of a new active institution (Housing Bank) into the specialised banking field. Since its establishment in 1974, the Housing Bank recorded spectacular growth, increasing its relative share in specialised credit from 17.5% in 1975 to 53.6% in 1977. This accordingly led to a remarkable decline in the relative shares of other SCIs as shown by the table.

Despite the relative increase in the absolute volume of specialised credit, the lower part of the same table demonstrates that the relative share of this type of credit in total credit extended by the banking system rose only slightly from 23.7% in 1967 to 24.6% by 1977. Specialised credit formed, on average, 21.6% of total credit throughout the whole period. Commercial banks continued to dominate in the banking system in extending credit, with an average share of 70.5%. The relative importance of commercial banks decreased throughout the period, declining from 76.3% to 61.8% between 1967 and 1977. This was partly due to the continuous rise in specialised credit, and partly to the entry, in 1970, of the Central Bank of Jordan into the field of credit

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(1) However, a large proportion of this increase was a reflection of price inflation, given an average rate of inflation of 15% per annum during this period. The above rise in specialised credit therefore only doubled in real terms.

Table 8.1

## The Relative Share of Specialised Credit in Total Credit Extended by the Banking System, 1967 - 1977

(In millions of JD)

| | Year of Estab-lishmt. | 1967 | | 1968 | | 1969 | | 1970 | | 1971 | | 1972 | | 1973 | | 1974 | | 1975 | | 1976 | | 1977 | | Average % 1967-1977 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Value | % | Value | % | Value | % | Value | % | Value | % | Value | % | Value | % | Value | % | Value | % | Value | % | Value | % | |
| 1. Municipal & Village Loans Fund | 1957 | 3.47 | 28.7 | 3.94 | 29.4 | 3.96 | 28.6 | 4.21 | 29.9 | 4.64 | 31.2 | 4.95 | 30.5 | 5.22 | 29.8 | 5.59 | 24.9 | 6.46 | 21.3 | 7.60 | 14.1 | 9.07 | 11.3 | 25.5 |
| 2. Agricultural Credit Corp. | 1960 | 5.97 | 49.4 | 6.40 | 47.7 | 5.95 | 44.5 | 5.92 | 42.0 | 5.91 | 39.7 | 6.41 | 39.5 | 7.27 | 41.5 | 7.98 | 35.5 | 8.87 | 29.2 | 9.72 | 18.0 | 10.65 | 13.3 | 36.5 |
| 3. Industrial Development Bank | 1965 | 1.37 | 11.3 | 1.60 | 11.9 | 1.83 | 13.7 | 2.31 | 16.4 | 2.51 | 16.9 | 2.74 | 16.9 | 3.04 | 17.4 | 3.99 | 17.7 | 5.53 | 18.2 | 7.87 | 14.6 | 10.85 | 13.6 | 15.3 |
| 4. Housing Agency | 1965 | 0.51 | 4.3 | 0.80 | 6.0 | 0.80 | 6.0 | 0.84 | 6.0 | 1.03 | 6.9 | 1.28 | 7.9 | 1.16 | 6.6 | 2.83 | 12.6 | 2.44 | 8.0 | 2.34 | 4.3 | 2.77 | 3.4 | 6.5 |
| 5. Jordan Co-operative Organisation | 1968 | 0.76 | 6.3 | 0.68 | 5.0 | 0.83 | 6.2 | 0.80 | 5.7 | 0.78 | 5.3 | 0.86 | 5.2 | 0.83 | 4.7 | 1.13 | 5.0 | 1.75 | 5.8 | 3.08 | 5.7 | 3.84 | 4.8 | 5.4 |
| 6. Housing Bank | 1974 | - | | - | | - | | - | | - | | - | - | - | - | 0.97 | 4.3 | 5.31 | 17.5 | 23.35 | 43.3 | 42.96 | 53.6 | 10.8 |
| A. Total Specialised Credit (1 to 6) | | 12.08 | 100 | 13.42 | 100 | 13.37 | 100 | 14.08 | 100 | 14.87 | 100 | 16.24 | 100 | 17.52 | 100 | 22.49 | 100 | 30.36 | 100 | 53.96 | 100 | 80.14 | 100 | 100.0 |
| B. Commercial Bank Credit | | 38.89 | | 41.00 | | 45.39 | | 45.55 | | 46.93 | | 50.59 | | 61.82 | | 83.93 | | 121.43 | | 183.74 | | 201.10 | | |
| C. Central Bank Credit* | | - | | - | | - | | 3.43 | | 4.74 | | 8.27 | | 16.58 | | 11.94 | | 17.66 | | 31.46 | | 44.05 | | |
| D. Total Credit of the Banking System (A + B + C) | | 50.97 | | 54.42 | | 58.76 | | 63.06 | | 66.54 | | 75.10 | | 95.92 | | 118.36 | | 169.45 | | 269.16 | | 325.29 | | |
| Col. (A) as perct. of Col. (D) | | 23.7 | | 24.7 | | 22.8 | | 22.3 | | 22.3 | | 21.6 | | 18.3 | | 19.0 | | 17.9 | | 20.0 | | 24.6 | | 21.6 |
| Col. (B) as perct. of Col. (D) | | 76.3 | | 75.3 | | 77.2 | | 72.3 | | 70.5 | | 67.4 | | 64.4 | | 70.9 | | 71.7 | | 68.3 | | 61.8 | | 70.5 |
| Col. (C) as perct. of Col. (D) | | - | | - | | - | | 5.4 | | 7.2 | | 11.0 | | 17.3 | | 10.1 | | 10.4 | | 11.7 | | 13.6 | | 7.9 |

Source: Central Bank of Jordan, Monthly Statistical Bulletins.

* Includes advances & Bills Rediscounted to Commercial Banks and specialised institutions plus advances to Government.

extension. The share of the latter gained in relative importance over the years, rising from only 5.4% in 1970 to 13.6% by 1977.

There now follows a series of four case studies of the four main economic sectors in which institutions were created, viz. agriculture, manufacturing, housing, and municipal and rural affairs - sectors of prime significance in domestic development programmes. Their priority is reflected in their high relative share in total investment under the country's development plans, as shown by Table 8.2. The Five Year Plan placed even further emphasis on the development of these sectors, thus raising their relative share in total investment to 64.2% as compared

Table 8.2 The Significance of the Main Priority Sectors in Total Plans' Investment

%

| Sector | Three Year Plan 1973-1975 | Five Year Plan 1976-1980 |
|---|---|---|
| 1. Agriculture | 15.5 | 17.9 |
| 2. Manufacturing (including mining) | 14.5 | 30.0 |
| 3. Housing | 19.5 | 11.2 |
| 4. Municipal and Rural Affairs | 8.2 | 5.1 |
| Total (1+2+3+4) | 57.7 | 64.2 |
| Total Plan Investment | 100.0 | 100.0 |

Source: National Planning Council, Three Year Plan (P.36); Five Year Plan (P.64)

with 57.7% under the Three Year Plan. Among these sectors, the manufacturing was particularly encouraged, its relative share rising from 14.5% to 30.0% during the two plans' periods respecitvely.

# I

## The Agricultural Sector

### I.1. The Need For Specialised Agricultural Credit

Agriculture constitutes an important sector in the Jordanian economy, being 17% of GNP and employing 18% of the total labour force.(1) Due mainly to the high risks and uncertainties involved in agricultural investment, profit expectations failed to stimulate an adequate inflow of private funds towards agricultural activities. Chapter 4 showed that only a small average of 2.3% of commercial banks' credit went in favour of the agricultural sector.(2) Agriculturalists, especially small farmers, had therefore to resort to non-institutional sources of funds, such as money-lenders and shopkeepers, to meet their financial requirements against extremely high rates of interest. This situation led the government to intervene in the market by setting up specialised institutions for financing and promoting agricultural development. These are now represented by the Agricultural Credit Corporation and the Jordan Co-operative Organisation.

### I.2. Specialised Financial Intermediaries in the Agricultural Sector:

#### I.2.1. The Agricultural Credit Corporation (ACC)

The ACC was established in 1959 to replace the three inefficient existing specialised agencies operating in the agricultural sector - the Agricultural Bank (formerly created in Transjordan in 1920), the Village Loan Scheme (administered by the Jordan Development Board), and the Agricultural Co-operative (administered by a separate government department).(3) These agencies operated quite independently from each other

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(1) For GNP contribution, see Chapter 4, Table 4.7; and for the employment firgures, see Five Year Plan, op.cit. P.25

(2) Chapter 4. Table 4.7

(3) Khayyat, Abdul Razzak, Government Rural Supervised Credit in U.S.A. and Jordan, MS.c. Thesis, (U.S.A.: Colorado State University: Spring 1966) P.4

which led to a high degree of counter productive overlapping in their operations.(1) Moreover, none of the above agencies had enough resources to meet the demand of farmers, nor did they have adequate qualified staff to operate efficiently.(2) To improve this situation, the Government finally decided to create the ACC which became the major source of finance in the agricultural sector.

The ACC is a semi-autonomous government insititution aiming at providing all credit-worthy farmers with a source of credit to keep them in business, increasing their farm production, raising their income level, and protecting them from resorting to merchants and money lenders.(3) For this purpose, the ACC extends its credit to individual farmers, agricultural projects and other agro-industries with immediate impact on promoting agricultural activities. Since it commenced operations in 1960 up to 1977, the ACC extended 33,031 loans valued at JD 23.11 million to some 50,366 borrowers. These loans were of special importance because they were granted for long-term periods, which appropriately suited the development requirements of the agricultural sector. As can be seen from Table 8.3, loans of medium and long-term maturities comprised, on average, 91.1% of total credit throughout the period 1960-1977; the remaining percentage of 8.9% was in the form of short-term and seasonal credit to finance current farm expenses, such as payment of labour costs and purchase of fertilizers and seeds. The medium-term loans were used mainly to finance the purchase of farm machinery, and physical improvement of agricultural land, and the promotion of livestock farms and poultry industry. The long-term loans were issued for construction of farm

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(1) Ibid.

(2) Sharabi, Burham,"Agricultural Credit in Jordan', A Paper Presented at the Agricultural Capital Project Course ( Amman: June 20 - July 26, 1973) P.2

3. Aresvik, Oddvar, The Agricultural Development of Jordan, (London: Praeger Publishers, inc. 1976) P.272

Table 8.3 Loans Extended by the Agricultural Credit Corporation, 1960 - 1977

| Year | No. of Transac-tions | No. of Borrow-ers | Value of Loans (JD'000) | Relative Importance of | |
|---|---|---|---|---|---|
| | | | | Short-term Credit % | Medium & Long-Term Credit % |
| 1960 | 4,315 | 14,482 | 0,458 | 50.7 | 49.3 |
| 1961 | 2,000 | 2,618 | 0,470 | 13.5 | 86.5 |
| 1962 | 2,688 | 3,433 | 1,036 | 4.8 | 95.2 |
| 1963 | 2,938 | 3,485 | 0,903 | - | 100.0 |
| 1964 | 1,763 | 2,223 | 0,833 | - | 100.0 |
| 1965 | 2,049 | 2,658 | 1,207 | - | 100.0 |
| 1966 | 2,147 | 2,588 | 1,294 | - | 100.0 |
| 1967 | 1,331 | 1,733 | 0,675 | - | 100.0 |
| 1968 | 1,350 | 1,607 | 0,747 | - | 100.0 |
| 1969 | 832 | 1,100 | 0,567 | 1.0 | 99.0 |
| 1970 | 868 | 1,114 | 0,438 | 8.9 | 91.1 |
| 1971 | 1,616 | 1,955 | 0,710 | 10.2 | 89.8 |
| 1972 | 1,592 | 2,032 | 1,439 | 6.8 | 93.2 |
| 1973 | 2,448 | 3,020 | 1,844 | 15.1 | 84.9 |
| 1974 | 1,617 | 2,122 | 2,139 | 10.2 | 89.8 |
| 1975 | 1,632 | 1,618 | 3,190 | 9.0 | 91.0 |
| 1976 | 1,029 | 1,412 | 2,792 | 12.7 | 87.3 |
| 1977 | 816 | 1,166 | 2,368 | 16.4 | 83.6 |
| Total | 33,031 | 50,366 | 23,110 | | |
| Aver. 1960-1977 | 1,835 | 2,798 | 1,284 | 8.9 | 91.1 |

Source: Agricultural Credit Corporation, Annual Reports, 1960 - 1977

buildings, major irrigation projects and the establishment of agricultural industries and marketing facilities. All the above types of credit were extended against comparatively lower rates of interest as compared with those charged by commercial banks, ranging from 6% for medium and long-term loans to 8% for short-term loans. The rate of interest on the latter category was subject to a 1% discount if farmers repaid their loans in due time.(1)

The significance of ACC's credit is further emphasised by the fact that this specialised credit was largely extended to projects with a close connection to development programmes. As a development institution, the ACC applied both profitability and economic development priority criteria when selecting projects for finance. An interviewed head of department in the ACC explained that his institution gave priority to finance projects which fell within the framework of development plans. This was the case especially for big projects which had immediate impact on promoting agricultural output. Prior to the approval of a loan, ACC technical staff usually prepares an agricultural plan for the proposed project, revealing the financial aspects of the project and its profitability, the specific purposes of the loan required, and also the expected ways by which the implementation of the project can promote general agricultural and economic activities. Moreover, loans are normally supervised and controlled by the ACC to ensure that they are used for the specific purpose for which they are granted.

In extending credit, the ACC requires certain collateral which usually takes the form of immovable property, such as agricultural land. The maximum ceiling of loans granted should not exceed 75% of the assessed value of the securities provided. Although this type of collateral is usually required by ACC, other types of security can, in certain circumstances, be accepted especially where borrowers are small farmers,

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(1) Agricultural Credit Corporation, "A Historical Review of Agricultural Credit in Jordan', (Amman: Undated Internal Paper, in Arabic) P.2

or those who do not own land at all. In such cases, a financial security may be accepted with the maximum ceiling for each loan not exceeding JD 500, secured by two guarantors of good financial standing. In rare cases, moreover, shares and stocks can also be used as security for loans up to the extend of 80% of their value.(1) As will be shown later, the concentration on mortgage of land as collateral has greatly minimised the opportunity for small farmers and non-owner farmers to obtain adequate funds from the ACC.

However, the emphasis on good collateral, which mostly implied first rate mortgage on immovable properties, was necessitated by the hard experience of agricultural credit in Jordan, as reflected in the low rate of loans recovered. The repayment record of ACC has not been satisfactory over the period under review, as can be seen by Table 8.4. Despite some improvements in the rate of collection in recent years, the repayment of instalments due has been noticeably low, averaging around 44% during the whole period. This situation can be explained by three main factors. Firstly, when the ACC was created to replace the three institutions previously operating in the agricultural sector, it had also to inherit the assets of these institutions, which were mainly loans extended to farmers. These loans had a very low recovery rate since they were mostly granted only in emergency cases, and were thus considered as welfare loans.(2) Such unpaid loans were transferred to the ACC which accordingly affected the general rate of loan collection. Secondly, the high dependence of Jordanian agriculture on rainfall which led to high fluctuation in agricultural production.(3) The fully irrigated

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(1) For collateral requirements, see O. Aresvik, op.cit. P.274

(2) O. Aresvik, op.cit. P. 276

(3) Such fluctuations were clearly reflected in the contribution of agriculture to GNP. See Chapter 4. Table 4.7

Table 8.4 Loans Recovered and Loans due for Recovery for the Period 1961 - 1977

| Year | Loans Recovered (JD'000) (1) | Loans Due For Recovery (JD'000) (2) | Loan Recovery Ratio (3) =(1) as% of (2) |
|---|---|---|---|
| 1961 | 0,427 | 1,039 | 41.1 |
| 1962 | 0,634 | 0,639 | 99.2 |
| 1963 | 0,474 | 1,441 | 32.9 |
| 1964 | 0,708 | 1,267 | 55.9 |
| 1965 | 0,691 | 1,127 | 61.3 |
| 1966 | 0,462 | 1,600 | 28.9 |
| 1967 | 0,501 | 1,904 | 26.3 |
| 1968 | 0,404 | 2,479 | 16.3 |
| 1969 | 0,691 | 2,184 | 31.6 |
| 1970 | 0,445 | 2,438 | 18.3 |
| 1971 | 0,639 | 2,294 | 27.8 |
| 1972 | 0,821 | 3,731 | 22.0 |
| 1973 | 0,856 | 1,770 | 48.0 |
| 1974 | 1,192 | 2,031 | 58.7 |
| 1975 | 1,939 | 3,097 | 62.3 |
| 1976 | 1,658 | 2,893 | 57.3 |
| 1977 | 1,756 | 2,875 | 61.1 |
| Average 1961 - 1977 | | | 44.0 |

Source: (1) For the period 1961 - 1970, see B. Sharabi, op.cit. P.10

(2) For the period 1971 - 1977, the Annual Reports of the ACC.

agricultural area comprised only 7% of the total cultivated land.(1) Naturally, this situation made it difficult for farmers to repay loans during years of drought. Thirdly, continuous political instability in the region further reduced the ability of the ACC to recover its credit. The 1967 War, and the consequent occupation of the West Bank of Jordan, made it almost impossible for the ACC to collect loans granted there. Moreover, successive Israeli raids on the Jordan Valley and the Ghor area (the most fertile agricultural land) after 1967 led to serious disruption of agricultural production. This was further worsened by the internal disturbances of 1970, which seriously affected the overall performance of the Jordanian economy. All these factors worked to reduce the ability of the ACC to recover its loans.

I.2.2. The Jordan Co-operative Organisation (JCO)

The history of the organised co-operative movement in Jordan can be traced back to 1952, when the first co-operative law No. 39 was issued to establish the co-operative department within the Ministry of Social Affairs and Labour.(2) This encouraged the creation of co-operatives which were mainly agricultural credit and thrift societies, similar to those of the Raiffeisen organisations in Germany.(3) Their function was to provide their members with small seasonal loans. Initially, the co-operatives were concentrated mainly in the rural areas of the country where the need for their services was highly demanded. Their purpose was to fill a certain gap in the credit system resulting from the concentration of organised credit in urban areas. Even when credit was available

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(1) Total cultivated area in the East Bank of Jordan was 350,000 hectares, out of which only 25,000 were fully irrigated. See IBRD, Current Economic Position and Prospects of Jordan (October 1972) P.22

(2) Jordan Co-operative Organisation, "Co-operative Societies in Jordan, 1972 - 1977", (Amman: March 1978, In Arabic) P.1

(3) O. Aresvik, op.cit. P. 278

in rural areas, it was largely confined to big borrowers who were able to provide the required collateral. Small farmers were unable to obtain sufficient funds from the organised market, due to the absence of adequate collateral and because of the high risk associated with small agricultural units. Such borrowers had, therefore, to resort to money lenders to finance their needs against high rates of interest reaching 50%.(1) To improve this situation, the co-operative movement placed particular emphasis on meeting the needs of small farmers and reducing, as far as possible, the influence of money lenders in the agricultural sector.

Thus, the 1952 co-operative law was followed by an active co-operative movement throuhgout the country. By 1964, the number of co-operative societies had increased to 688 as compared with 42 in 1952. During this period, as Table 8.5 shows, their membership rose from only 2,000 to 44,438 with total credit reaching JD 1.19 million. Credit extended to members was increasingly financed by the share capital of the co-operatives and their members' deposits. The former financed 24% of credit extended in 1964 as compared with 19% in 1952, whereas the latter increased its relative share from only 0.1% to 10% during the same period.

As the co-operative societies increased in number, so many governmental agencies were established to finance and assist this expansion. The Jordan General Co-operative Union was first established in 1959 to provide financial assistance as well as other supplying and marketing facilities. This was followed by the setting up of the Co-operative Training Centre

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(1) Jordan Co-operative Organisation, Co-operative Societies in Jordan, 1972 - 1977, op.cit. P.1

Table 8.5 Development in Number, Membership, Capital, Deposit and Credit Extended by Co-operative Societies, 1952 - 1977*

| Year | Number of Societies | Number of Members | Share Capital (JD) | Member Deposits (JD) | Member Loans (JD) |
|---|---|---|---|---|---|
| 1952 | 42 | 2,000 | - | - | - |
| 1953 | 50 | 2,091 | 8,643 | 29 | 44,256 |
| 1954 | 69 | 3,193 | 12,337 | 172 | 72,322 |
| 1955 | 134 | 6,123 | 38,697 | 6,737 | 163,137 |
| 1956 | 161 | 8,833 | 52,016 | 23,837 | 246,038 |
| 1957 | 209 | 11,646 | 81,801 | 45,666 | 467,248 |
| 1958 | 247 | 14,520 | 33,086 | 37,296 | 584,680 |
| 1959 | 255 | 15,031 | 169,290 | 70,577 | 640,627 |
| 1960 | 335 | 21,103 | 188,555 | 77,683 | 616,207 |
| 1961 | 428 | 29,143 | 221,792 | 89,110 | 622,391 |
| 1962 | 589 | 30,331 | 238,564 | 97,537 | 748,225 |
| 1963 | 636 | 30,969 | 307,667 | 135,339 | 1,084,514 |
| 1964 | 688 | 44,438 | 292,808 | 118,273 | 1,188,786 |
| 1965 | 702 | 43,058 | 333,035 | 136,354 | 1,201,982 |
| 1966 | 709 | 43,299 | 332,754 | 164,896 | 1,208,669 |
| 1967 | 716 | 43,461 | 353,217 | 180,352 | 1,189,102 |
| 1968 | 710 | 42,159 | 344,688 | 173,116 | 972,521 |
| 1969 | 680 | 43,599 | 354,689 | 154,423 | 930,423 |
| 1970 | 695 | 44,771 | 422,921 | 163,238 | 974,677 |
| 1971 | 712 | 45,156 | 452,626 | 160,397 | 1,172,471 |
| 1972 | 720 | 47,140 | 513,162 | 168,897 | 673,487 |
| 1973 | 464 | 26,923 | 654,661 | 173,953 | 1,253,682 |
| 1974 | 474 | 29,808 | 883,824 | 210,882 | 1,436,140 |
| 1975 | 492 | 33,332 | 1,304,314 | 255,109 | 1,982,884 |
| 1976** | n.a. | n.a. | 2,478,459 | 321,816 | 2,611,822 |
| 1977** | 635 | 50,629 | 3,664,487 | 536,585 | 2,942,397 |

Source: JCO, Annual Statistical Bulletin, 1975, 1977

*Covers both the East Bank and West Bank of Jordan.

** Member Deposits and loans for 1976 and 1977 cover the East Bank only.

in 1963 and the Co-operative Audit Union in 1964 to render essential services to co-operative societies.(1) The former concentrated on providing adequate co-operative culture and education, besides training accountants, managers, and other required personnel. The latter was, on the other hand, responsible for auditing the financial accounts of the co-operatives and organising their budgets. However, due to the lack of co-ordination in the activities of these agencies, and because of the high degree of overlapping in their operations, the Government recognised the need for establishing a new specialised institution capable of handling all co-operative affairs in the country. Thus, a new start was made with the introduction of the Co-operative Law No. 55 of 1968, which provided for the establishment of the Jordan Co-operative Organisation (JCO) to replace the formerly existing agencies, and to act as a parent institution for all the co-operative societies operating in the country.(2)

With its capital being jointly shared between the co-operative societies and the Government, the JCO aimed at assisting the development of different co-operatives, particularly those catering for the needs of small and medium-sized farmers and artisans. The Jordanian experience showed that the obstacle hindering the development of the rural sector had both financial as well as technical aspects.(3) The former reflected the difficulty of channelling adequate funds to small and medium-sized farmers, whereas the latter represented the lack of technical expertise and sound management among farmers who had little or no business experience.(4)

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(1) For the development of these institutions and their functions, see the JCO, Co-operative Societies in Jordan, 1972 - 1977, op.cit. P.2

(2) Arafeh, M., Howarth, F., and Klemann, P., "The Co-operative Movement in Jordan", (Amman: Report Published by the JCO, July 1977) P.4

(3) Ibid. P. 34

(4) Ibid.

As a development institution, the JCO faced both aspects of the problem and concentrated its efforts on overcoming them. On the one hand, it acted as a banker for co-operatives and their members, including the provision of all types of loans. On the other hand, it promoted the growth of all co-operatives by providing technical advisory services, supplying and marketing different agricultural items, and by training staff and members of co-operatives.

As a supplier of funds, the JCO provided co-operative societies with loans to help them in meeting their commitments towards their members. Loans extended increased more than five times during the three years covered in Table 8.6, rising from JD 0.38 million in 1974 to JD 3.39 million by 1977. During this period, an average of 41.3% of total credit was in the form of seasonal and short-term loans, used to finance the members' needs for seeds, chemicals, fertilizers and other current co-operative expenses. Medium-term credit comprised, on average, 36.2% of total credit. Such loans were used mainly to purchase equipment and to improve agricultural land. Longer-term loans accounted for an average of 2.2%, extended to finance construction purposes. Interest charged on the above loans ranged between 6% and 8%, depending on maturity, purpose, and type of co-operative.(1)

The repayment record of the JCO appeared to be more satisfactory as compared with the ACC. During 1974 - 1977, the rate of collection of loans averaged around 84.9% of loans due for recovery. This ratio can be compared with a lower ratio for the ACC, which accounted for 59.8% during the same period.(2) An interviewed manager in the ACC

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(1) JCO, Co-operative Societies in Jordan, 1972 - 1977, op.cit. P.16 & 17

(2) See Table 8.4

Table 8.6 Co-operative Credit Extended by the JCO and the Ratio of Loans Recovery, 1974 - 1977

| Year | Loans Issued (JD'000) (1) | Relative Importance of loans classified According to: (2) | | | | | | Loans Recovered (3) (JD'000) | Loans Due For Recovery (4) (JD'000) | Loans Recovery Ratio (5) = (3) as% of (4) |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Purpose | | Maturity | | | | | | |
| | | Agr. | Non-Agr. | Short-term | Medium-Term | Long-Term | Others* | | | |
| 1974 | 0,358 | 59.5 | 40.5 | 56.7 | 11.2 | - | 32.1 | 0,280 | 0,368 | 78.1 |
| 1975 | 1,333 | 78.2 | 21.8 | 31.6 | 30.5 | 2.3 | 35.6 | 0,507 | 0,622 | 81.5 |
| 1976 | 2,246 | 87.6 | 12.4 | 38.0 | 53.6 | 3.6 | 4.8 | 0,921 | 1,036 | 88.9 |
| 1977 | 3,393 | 86.7 | 13.3 | 38.7 | 49.4 | 3.0 | 8.9 | 1,272 | 1,399 | 90.1 |
| Average ratio 1974-1977 | | 78.0 | 22.0 | 41.3 | 36.2 | 2.2 | 20.3 | | | 84.9 |

Source: JCO, Annual Statistical Bulletin, 1974 - 1977

* Includes unclassified maturity loans such as Tobacco Loans and Loans extended to co-operatives under liquidation.

related the relative success of the JCO in collecting its loans as compared with the ACC to the difference in the procedures of loans extension in both institutions. According to its law, the JCO cannot extend new credit to any co-operative unless the latter repays all loans due for recovery. This encouraged co-operatives to repay loans in due time in order to obtain new credit, thus leading to a general rise in the loan recovery ratio.

Table 8.6 also reveals the interest of the co-operative movement in the agricultural sector which claimed, on average, more than three quarters of total co-operative credit during 1974 - 1977. The relative importance of credit extended to agricultural co-operatives was gaining in importance, increasing from 59.5% in 1974 to 86.7% by 1977. This increase occurred despite the decline in the relative size of the agricultural societies in the co-operative sector, as measured by their number and the size of their membership. Table 8.7 illustrates that the relative size of agricultural societies in the co-operative sector showed a continuous decline over the period, dropping from 74.1% in 1970 to 43.4% by 1977. This decline can be explained by two reasons. Firstly, the number of agricultural co-operatives decreased in absolute terms from 146 in 1970 to 131 by 1977. This was mainly a result of amalgamation and re-organisation of the co-operatives operating in the agricultural sector to take a wider range of responsibilities. This took the form of bigger units called 'multi-purpose co-operatives' for providing farmers with a full range of services, with credit and supply constituting their major activities. However, despite the decline in the absolute number of agricultural societies, their membership rose from 5,938 to 10,435 between 1974 and 1977 - a reflection of forming bigger size co-operatives to replace the formerly operating small ones, which had limited purposes. Secondly, the decline in the relative size of agricultural societies was also due to a noticeable expansion of the co-operative

Table 8.7

## Number of Co-operatives and their members Classiffied According to Type of Co-operative, 1970 - 1977*

| Type of Co-operative | Number of Societies | | | | | | | | Number of Members | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1970 | 1971 | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | 1970 | 1971 | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 |
| Agricultural Rural Thrift & Credit Societies | 106 | 104 | 100 | 82 | 78 | 28 | - | | 4,382 | 3,352 | 2,753 | n.a. | 1,925 | 717 | - | |
| Agricultural Multi-purpose | 31 | 37 | 40 | 31 | 50 | 66 | 102 | | 1,205 | 1,460 | 1,796 | n.a. | 2,498 | 4,654 | 8,339 | |
| Agricultural Mark-eting** | 9 | 10 | 9 | 10 | 9 | 9 | 13 | | 351 | 354 | 345 | n.a. | 331 | 365 | 796 | |
| A. Total Agr. Societies | 146 | 151 | 149 | 123 | 137 | 103 | 115 | 131 | 5,938 | 5,103 | 4,984 | n.a. | 4,754 | 5,735 | 9,135 | 10,435 |
| Non-Agricultural Urban Thrift & Credit Societies | 9 | 11 | 12 | 11 | 11 | 12 | 13 | 14 | 619 | 790 | 1,472 | n.a. | 2,191 | 2,925 | 3,364 | 2,768 |
| Mutual Benefit | 20 | 27 | 34 | 45 | 51 | 65 | 67 | 67 | 1,276 | 1,885 | 2,583 | n.a. | 4,418 | 5,591 | 6,445 | 6,671 |
| Artisans | 7 | 7 | 6 | 7 | 6 | 6 | 6 | 6 | 143 | 176 | 148 | n.a. | 135 | 130 | 125 | 123 |
| Housing | 7 | 9 | 10 | 14 | 27 | 49 | 68 | 55 | 306 | 351 | 467 | n.a. | 1,171 | 1,942 | 4,524 | 3,579 |
| Consumer & Supply | 4 | 4 | 5 | 4 | 8 | 3 | 4 | 3 | 505 | 568 | 618 | n.a. | 1,518 | 748 | 2,764 | 557 |
| Multi-purpose | 4 | 5 | 6 | 6 | 9 | 16 | 22 | 26 | 618 | 703 | 766 | n.a. | 1,244 | 1,883 | 1,049 | 3,582 |
| B. Total Non-Agr. Soc. | 51 | 63 | 73 | 87 | 112 | 151 | 180 | 171 | 3,467 | 4,473 | 6,054 | n.a. | 10,677 | 13,219 | 18,271 | 17,280 |
| C. Grand Total | 197 | 214 | 222 | 210 | 249 | 254 | 295 | 302 | 9,405 | 9,576 | 11,038 | n.a. | 15,431 | 18,954 | 27,406 | 27,715 |
| (A) as a % of (C) | 74.1 | 70.5 | 67.1 | 58.6 | 55.0 | 40.6 | 38.8 | 43.4 | 63.1 | 53.3 | 45.2 | n.a. | 30.8 | 30.3 | 33.3 | 37.7 |

Source: (1) Aresvik, The Agricultural Development of Jordan, op.cit. Table 13.5, P. 280

(2) JCB, Annual Statistical Bulletin, 1974 - 1977

* Figures For the East Bank of Jordan only. ** Includes also Olive Oil Press and Tobacco Societies.

movement to cover areas outside the agricultural sector, such as urban thrift and credit, mutual benefits, housing, consumer, crafts and artisans. The number of these non-agricultural co-operatives rose from only 51 in 1970 to 171 by 1977. Their members also witnessed a continuous rise, reaching 17,280 in 1977, as compared with merely 3,467 in 1970. This expansion has been largely assisted by the financial and technical services rendered by the JCO.

## I.3. Conclusions and Assessment of Specialised Agricultural Credit

As development agencies, the ACC and the JCO have undoubtedly promoted the growth of the agricultural sector. Their contribution to agricultural development had both financial as well as technical aspects. On the financial side, specialised credit granted by these institutions represented the major source of institutional finance in the agricultural sector, accounting on average 78.9% throughout the period 1970 to 1977. The remaining percentage of 21.1% was financed by the commercial banks which formed the other source of institutional credit. An examination of Table 8.8, however, shows that specialised credit decreased in relative importance from 92.0% in 1970 to 63.5% in 1977. This decline, particularly since the launching of the development programme of 1973, was attributed to the rise in the proportion of commercial banks' credit going to agriculture. As the table demonstrates, the relative share of bank credit rose from only 10% in 1972 to 20.3% in 1973, and continued to rise over the years, reaching 36.5% by 1977. This increase occurred at the expense of the relative share of credit extended by the ACC, which was almost halved, declining from 81.1% to 46.7% between 1970 and 1977.

Despite the decline in the relative importance of specialised loans, this type of credit continued to claim the major element of institutional finance in 1977, comprising about two thirds of the total. However, the significance of specialised credit was in fact related to its long-term nature which was necessary to finance the development requirements

Table 8.8 Relative Importance of Specialised Agricultural Credit in Total Institutional Finance Available in the Agricultural Sector, 1970 - 1977

(JD'000)

| Institution | 1970 | 1971 | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | Aver. % 1970 -77 |
|---|---|---|---|---|---|---|---|---|---|
| A. Specialised Credit | 6,719 | 6,682 | 7,271 | 8,094 | 9,105 | 10,626 | 12,799 | 14,483 | |
| 1. ACC | 5,922 | 5,912 | 6,408 | 7,269 | 7,976 | 8,867 | 9,724 | 10,644 | |
| 2. JCO | 0,797 | 0,770 | 0,863 | 0,825 | 1,129 | 1,759 | 3,075 | 3,839 | |
| B. Commercial Banks' Agr. Credit | 0,583 | 0,799 | 0,804 | 2,061 | 3,745 | 3,608 | 5,162 | 8,311 | |
| C. Total Agr. Credit (A + B) | 7,302 | 7,481 | 8,075 | 10,155 | 12,850 | 14,234 | 17,961 | 22,794 | |
| (A) as a % of (C) | 92.0 | 89.3 | 90.0 | 79.7 | 70.9 | 74.7 | 71.3 | 63.5 | 78.9 |
| (B) as a % of (C) | 8.0 | 10.7 | 10.0 | 20.3 | 29.1 | 25.3 | 28.7 | 36.5 | 21.1 |
| (1) as a % of (C) | 81.1 | 79.0 | 79.3 | 71.6 | 62.1 | 62.3 | 54.2 | 46.7 | 67.0 |
| (2) as a % of (C) | 10.9 | 10.3 | 10.7 | 8.1 | 8.8 | 12.4 | 17.1 | 16.8 | 11.9 |

Source: (1) CBJ, Monthly Statistical Bulletin (Nov. 74)

(2) ___, Monthly Statistical Bulletin (June 78)

of agriculture. Bank Credit was always confined to short-term loans. The ACC and the JCO were the only institutional source for long-term agricultural credit. Moreover, the geographical extension of ACC and JCO services into rural and remote areas further increased the significance of specialised credit for the country's economic development. Appendix 8.1 shows that specialised credit furnished by the ACC was distributed between diffrent regions of the country, with the share of the Amman area comprising an average of 25.5% during the period 1973 - 1977. On the other hand, the JCO also expanded its activities to finance and promote co-operatives operating in different parts of Jordan. Appendix 8.2 reveals that 45.7% of total co-operatives were situated in Amman and Zerka area, whereas the remaining were located in other regions of the country. Such geographical distribution of specialised credit was in contrast to commercial banks' credit which was mainly concentrated in Amman and other major cities. Clearly, by extending their services to cover larger geographical areas, both the ACC and the JCO helped to minimise the adverse effects of the bias in the credit system, resulting from the concentration of bank branches in the main prosperous cities.

As far as the technical side of their contribution to agricultural development was concerned, the role of both institutions has been even greater. By preparing feasibility studies and advising farmers on technical aspects of their projects, the ACC worked to direct agricultural investment towards sound projects and helped farmers to overcome their ignorance of technical knowledge. On the other hand, the services offered by the JCO to the co-operative societies has assisted the development of the co-operative movement in rural areas. The promotional role of the JCO manifested itself, firstly, in providing co-operatives with sound management in the preparatory stage of their establishment,

then secondly, in rendering these co-operatives technical advisory services necessary for their operations, and finally, in operating adequate training programmes to educate and train co-operatives' members.

However, although the above discussion has clearly shown the significance of both specialised institutions in developing the agricultural sector, the financial needs of this sector have not been sufficiently met. The credit gap in the agricultural sector, though greatly reduced, still exists. According to ACC sources, the agricultural sector still did not receive sufficient funds necessary for its development.(1) This was also recognised by the Three Year Development Plan of 1973.(2) Available institutional credit from both the commercial banks and specialised institutions failed to satisfy the increasing demand for funds, which was intensified with implementing development programmes. Farmers, therefore, continued to resort to non-institutional sources of funds to finance their requirements. A study prepared by the ACC estimated that money lenders still comprised about one quarter of the organised finance in the agricultural sector.(3) The ACC justified its inability to adequately meet the demand for funds made by farmers to its limited financial resources.(4) An examination of the liabilities side of the ACC's balance sheet as of December 31, 1977(5) reveals the absence of any financial contribution made by the private sector. The ACC relied exclusively on funds provided by official sources

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(1) B. Sharabi, op.cit. P. 6

(2) National Planning Council, Three Year Development Programme, 1973-1975, op.cit. P. 60

(3) Agricultural Credit Corporation, "Agricultural Credit in Jordan" (Amman: Undated Report, In Arabic) P. 1

(4) Ibid. P. 3

(5) ACC, Annual Report, 1977

and by the International Development Association. Capital (government contribution) and net profits comprised 62% of total financial resources, whereas 33% constituted loans made by the government, the Central Bank, and the International Development Association. The ACC's financial capacity can be substantially increased by tapping private sector savings through issuing long-term agricultural bonds to be subscribed by individuals and private institutions. The introduction of such debt instruments can be assisted by the Central Bank, and should now be facilitated by the existence of the Amman Financial Market.

Although the co-operative societies were largely encouraged with the establishment of the JCO, the spread of the co-operative movement did not adequately extend to the rural sector of the economy. This was pointed out by development planners who prepared the Three Year Development Programme. The Plan revealed that the co-operative societies were not sufficiently distributed in the country, thus leaving a large area of the agricultural sector without their essential services.(1) In realising the significance of co-operatives in developing the agricultural sector, the Five Year Plan of 1976 greatly stressed the necessity of strengthening and expanding the co-operative movement, with a view to including the maximum possible number of farmers in different regions of the country.(2) The Plan also demanded the close co-ordination of credit policies of both the ACC and the JCO to encourage the organised co-operative movement within the general policy of agricultural development.(3) However, the absence of co-operatives in many parts of Jordan deprived small farmers of obtaining co-operative credit and forced them

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(1) National Planning Council, Three Year Development Programme, 1973-75, op.cit. P. 59

(2) _____., Five Year Development Programme , 1976 -80, op.cit. P97

(3) Ibid.

to resort to money lenders. This situation must have been exacerbated because a large number of small farmers could not obtain credit from the organised market, due mainly to the lack of adequate collateral. Small farmers constitute the bulk in the agricultural sector since the pattern of land ownership in Jordan is predominantly one of small-holdings.(1) This group of farmers (including non-owner-operators, such as sharecroppers and renters) found it difficult to obtain credit even from the ACC which specialised in financing agriculture. Although the announced policy of the ACC was intended to reach all types of farmers, especially the small ones,(2) it has been recognised that the prescription about security accepted by the ACC as collateral for loans (usually mortgage of land) has greatly minimised the opportunity of small farmers to obtain credit.(3) This was either because their land ownership was below the required level or because they did not own land at all.(4) As a result, such farmers had to resort either to co-operative societies or, if these were not available, to money lenders. This clearly requires further extension of the co-operative movement throughout the country as an essential step for effective agricultural development.

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(1) B. Sharabi, op.cit. P. 8

(2) B. Sharabi, op.cit. P. 8

(3) O. Aresvik, op.cit. P. 275

(4) Farmers who obtained funds from the ACC were those who owned land above two or three hectares in irrigated areas, and above ten hectares in dry areas. According to the 1965 agricultural census, more than half of the nearly 40,000 farms in the East Bank were below five hectares and about 25 per cent were below two hectares. On the other hand, non-owner-operators were ineligible to obtain credit from the ACC unless they could provide guarantors who owned land to secure the loans.
See ibid.

# II

# The Manufacturing Sector

## II.1. The Need for Specialised Manufacturing Credit

When independence was achieved in 1946, the manufacturing sector was in an embryonic stage of development, confined only to artisan production. Following independence, this sector expanded and diversified to include some basic industries catering for domestic needs. Throughout the two decades ending in 1976, manufacturing production grew rapidly at an average annual rate of 13%. This expansion has been particularly encouraged by the Three Year Plan of 1973 and the Five Year Plan of 1976, which both aimed at diversifying the economy's industrial structure by developing its manufacturing sector. Thus, by 1976, the relative contribution of manufacturing to GDP accounted for 18.2% as compared with 11.9% in 1973.(1) However, the development of this sector has been largely impeded by continuous political instability (such as the 1967 War and the 1970 civil disturbances) which created a high degree of uncertainty and accentuated pessimistic business expectations. Clearly, in unstable and uncertain circumstances, people tend to prefer investment in highly liquid forms with quick returns, rather than tying up their savings for longer-term activities, characteristic of the manufacturing sector. Such unfavourable conditions further intensified commercial banks' conservatism and accentuated their adherence to financing traditional lines of business available largely in the foreign trade sector. It was indicated in Chapter 4 that commercial banks made little contribution towards financing manufacturing expansion. Even when bank credit was extended to manufacturing, it was exclusively confined to short-term loans extended to big borrowers

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(1) See Chapter 4, Table 4.7

and well-established industries. The financial needs of medium and small-scale industries were not adequately met, and the long-term credit facilities necessary to develop this sector were conspicuously lacking. The government had, therefore, to fill such a gap in the credit system by deliberately creating a special institution for financing these needs.

## II.2. Specialised Financial Intermediaries in the Manufacturing Sector

### II.2.1. Industrial Development Bank (IDB)

The IDB was established in 1965 to absorb the activities previously undertaken by the Industrial Development Fund and the Development Bank of Jordan, which had both been responsible for industrial financing. The former Industrial Development Fund was established in 1957 to finance manufacturing and tourism activities, whereas the Development Bank of Jordan was created as early as 1952 to extend agricultural and industrial credit.(1) Due to lack of resources and duplication of efforts,(2) both agencies were unable to meet the increasing needs of manufacturers, which finally led the government to amalgamate them in one main institution capable of rendering adequate assistance to the manufacturing sector. Such government action came, in fact, in response to the recommendation of the Seven Year Plan of 1964, which clearly revealed the inadequacy of the previously operating agencies, particularly the Industrial Development Fund, in meeting the vital needs of this sector. The Plan showed that during the period 1959 to 1962, loans approved by the Fund amounted to JD 0.36 million, whereas a further JD 1.00 million of feasible and sound loan applications had to be refused for lack of funds.(3) This meant that the Fund approved only one quarter of the

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(1) U.N. "Financing of Manufacturing Industries in Selected Countries of the Middle East", Industrialisation and Productivity, (N.Y.: 1968) Bulletin No. 11, P. 98

(2) IBRD, The Economic Development of Jordan, op.cit. P.231

(3) Jordan Development Baord, Seven Year Programme for Economic Development, op.cit. P.212

total sound loan applications provided by customers. Clearly, this situation must have greatly hindered the development of viable manufacturing projects, which led the Plan to strongly recommend the establishment of a new specialised institution capable of assisting and promoting this sector. The proposed institution was expected to assist manufacturers by providing them with the required financial as well as technical assistance, thereby encouraging private investors to channel further resources into this priority sector.

The Government responded quickly to the above recommendation. One year after launching the Plan, the IDB was created as a mixed enterprise, with the Government financing one third of its authorised capital of JD 3.00 million. In order to encourage the private sector to subscribe the remaining JD 2.00, the government, firstly, paid in its whole share of capital and, secondly, guaranteed a minimum dividend of 6% per annum on shares held by the public and, finally, it exempted these dividends from income tax.(1) In case profits were insufficient to cover the minimum dividend, the government also guaranteed to pay the difference.(2) By 1977, the share capital of the private sector was fully subscribed, thus encouraging the IDB to raise its authorised capital to JD 6 million in order to mobilise further funds for industrial investment.

The IDB now operates within the legislative framework provided by Permanent Law No. 5 (1972). According to this Law, the Bank has been given powers to perform banking, as well as other promotional functions, related to industrial development. As a development bank, it was empowered to extend loans for different maturities besides fulfilling other promotional activities, such as providing technical assistance,

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(1) Industrial Development Bank, Law No. 5 of 1972 (Amman: Official Gazette No. 2351 Dated 16.3.1972) Article 20

(2) Ibid.

advisory services, preparing feasibility studies, and conducting marketing surveys. In order to encourage industrial expansion, the Law enabled the IDB to participate in the ownership of domestic enterprises. Furthermore, the Bank was also empowered to help different industries to raise capital by, firstly, issuing guarantees for loans obtained from other financial sources and, secondly, by underwriting of shares and debentures and, finally, by assisting the development of a domestic capital market. However, how far this has been fulfilled by the Bank after twelve years of operations will now be discussed.

In terms of finance, the extension of loans has been by far the Bank's largest sector of activity. The financial operations of the Bank were largely concentrated on credit extension rather than equity investment. Table 8.9 demonstrates that the amount of loans outstanding at the end of 1977 comprised 95.1% of total financial assistance, thus leaving only a small percentage (4.9%) in equity participation. As of December 31, 1977, the Bank's equity investment accounted for JD 0.53 million, which represented share holdings in eight major industrial projects.(1) Loans outstanding, on the other hand, amounted to some JD 10.31 million extended to 240 enterprises. The cumulative loans approved by the Bank throughout its history amounted to JD 18.55 million, distributed amongst 420 projects.(2) Out of this total, 82.5% went in favour of manufacturing industries and the remaining percentage of 17.5% was granted to projects in the field of tourism.(3) The sectoral breakdown of loans outstanding provided by table 8.9 reflected the structural pattern of Jordanian industry, which was largely concentrated on satisfying domestic demand. Apart from the

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(1) IDB, Annual Report, 1977, P. 21

(2) See Table 8.10

(3) Industrial Development Bank also specialises in financing the toursim sector, in addition to manufacturing industries.

Table 8.9 Outstanding Loans and Equity

Investment of the IDB as of December 31, 1977

JD'000

| Industry | Medium-Term (1) | | | Long-Term (2) | | | Total (3) | | |
|---|---|---|---|---|---|---|---|---|---|
| | No. of Loans | Value | %of (3) | No.of Loans | Value | %of (3) | No. of Loans | Value | % |
| Non-Metallic Mineral Products | 29 | 1,137 | | 12 | 616 | | 41 | 1,753 | 17.0 |
| Fabricated Metal Products | 1 | 90 | | 3 | 497 | | 4 | 587 | 5.7 |
| Food | 7 | 151 | | 11 | 1,133 | | 18 | 1,284 | 12.5 |
| Textile | 8 | 63 | | 10 | 580 | | 18 | 643 | 6.2 |
| Shoes Manufacturing | 6 | 195 | | 3 | 34 | | 9 | 229 | 2.2 |
| Chemicals | 12 | 255 | | 11 | 851 | | 23 | 1,106 | 10.7 |
| Plastic | 15 | 245 | | 7 | 321 | | 22 | 566 | 5.6 |
| Wood & Wooden Products | 3 | 29 | | 2 | 250 | | 5 | 279 | 2.7 |
| Paper & Paper Products | 1 | 5 | | 8 | 738 | | 9 | 743 | 7.2 |
| Beverages | 3 | 83 | | 6 | 235 | | 9 | 318 | 3.1 |
| Tobacco | 1 | 24 | | 2 | 45 | | 3 | 69 | 0.7 |
| Photography | 5 | 38 | | - | - | | 5 | 38 | 0.4 |
| Machines & Equipment | 17 | 250 | | 13 | 406 | | 30 | 656 | 6.4 |
| Others | 8 | 78 | | 5 | 213 | | 13 | 291 | 2.8 |
| Hotel & Tourism | 12 | 188 | | 19 | 1,482 | | 31 | 1,751 | 16.8 |
| A. Total Loans | 128 | 2,831 | 27.5 | 112 | 7,482 | 72.5 | 240 | 10,313 | 100.0 |
| B. Equity Investment | | | | | | | | 531 | |
| C. Total Financial Assistance | | | | | | | | 10,844 | |
| (A) as a % of (C) | | | | | | | | 95.1 | |
| (B) as a % of (C) | | | | | | | | 4.9 | |

Source: IDB, Annual Report, 1977

proportion going to hotels and other tourism activities, the major beneficiaries in the manufacturing sector were non-metallic mineral products, which absorbed a relative share of 17%, followed by food industries and chemical projects which claimed respectively 12.5% and 10.7% of total specialised credit.

The IDB's lending policy demonstrates its function as a development institution as distinct from a commercial banking concern. In contrast to commercial banks' short-term loans, credit extended by the IDB was only for medium and long-term maturities, with the relative importance of the latter comprising 72.5% of total loans outstanding at the end of 1977. The interest charged by the IDB of 8% (including 1% commission) was comparatively lower than that usually charged by the commercial banks.(1) The distinction between the two types of intermediaries manifested itself also in the specification of security required as collateral for loans. While commercial banks usually emphasise the type of assets available for collateral, the IDB also took into consideration criteria such as the earning potential of the enterprise and efficiency of its management.(2) Furthermore, the operational criteria of the IDB were also different from those adopted by ordinary commercial banks. While profitability was established as the only criterion to be observed when taking financing decisions in commercial banking, the acknowledgement of a project as meriting priority by the development plan was also of equal importance in the investment decisions of the IDB. Article 10 of the IDB's Law of 1972 stipulated that both bankable as well as economic development considerations should be taken together in selecting projects for finance.

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(1) As shown in Chapter 5, interest charged by commercial banks ranged around 9% plus an extra commission rate ranging between ½% and 2%.

(2) U.N., Studies On Development Problems In Selected Countries of the Middle East, 1973, (N.Y.: 1974) P. 21

Investment decisions were usually taken after a comprehensive study of the financial aspects of the project , and its profitability, in addition to the likely gain to the economy (in the sense of creating favourable effects on employment and improving the balance of payments position). Clearly, these operational lending policies had a direct promotional impact on industrial development.

The specialised loans extended by the IDB were essentially important for economic development because this type of credit was used to finance the purchase of fixed assets necessary for industrial expansion. Classified according to purpose, Table 8.10 shows that the bulk of 64.2% of total specialised credit was extended for purchasing machinery and equipment, 12% was used for factory construction, whereas the remaining percentage of manufacturing credit of 6.3% financed the purchase of raw materials. Such a distribution pattern of specialised credit, which favoured the financing of fixed assets, gave the allocation function of the IDB a special significance from the standpoint of economic development; particularly taking into account that commercial banks (another institutional source of financing manufacturing ) only granted short-term credit for financing working capital.

As far as promotional activity was concerned, the IDB was equipped with the necessary machinery for project evaluation. Prior to the approval of loans, comprehensive studies of the financial and technical aspects of the proposed projects were prepared, together with their overall impact on developing the national economy. In order to ensure the proper use of loans, a follow-up division was created in the Bank in 1971 to deal with loans granted from first disbursement to final repayment.[1] The aim was to keep the Bank informed of all developments

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(1) IDB, Annual Report, 1971, P. 11

Table 8.10 Loans Approved* by the IDB Classified According to Purpose, 1965 - 1977

| Year | No.of Loans | Total Amount JD'000 | Approved Loans Classified According to Purpose | | | | | | | | | | Average Loans JD'000 | Loans Recovery Ratio % |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | Manufacturing | | | | | | | | Tourism | | | |
| | | | Factory Construction | | Machinery | | Raw Materials | | Total | | | | | |
| | | | Value | % of (2) | Value | % of (2) | Value | % of (2) | Value | % of (2) | Value | % of (2) | | |
| | (1) | (2) | | | | | | | | | | | | |
| 1965-1972 | 168 | 4,491 | 0,468 | 10.4 | 1,864 | 41.5 | 1,087 | 24.2 | 3,418 | 76.1 | 1,072 | 23.9 | 0,026 | n.a. |
| 1973 | 39 | 1,467 | 0,065 | 4.4 | 1,268 | 86.4 | 0,087 | 5.9 | 1,419 | 96.7 | 0,048 | 3.3 | 0,038 | 81.7 |
| 1974 | 37 | 1,935 | 0,153 | 7.9 | 1,402 | 72.5 | - | - | 1,555 | 80.4 | 0,380 | 19.6 | 0,053 | 84.1 |
| 1975 | 41 | 2,436 | 0,412 | 16.9 | 1,957 | 80.3 | - | - | 2,369 | 97.2 | 0,068 | 2.8 | 0,059 | 90.2 |
| 1976 | 74 | 3,523 | 0,298 | 8.5 | 2,317 | 65.7 | - | - | 2,615 | 74.2 | 0,908 | 25.8 | 0,048 | 92.1 |
| 1977 | 61 | 4,702 | 0,832 | 17.7 | 3,095 | 65.8 | - | - | 3,927 | 83.5 | 0,775 | 16.5 | 0,077 | 75.3 |
| Grand Total 1965-1977 | 420 | 18,554 | 2,228 | 12.0 | 11,901 | 64.2 | 1,174 | 6.3 | 15,303 | 82.5 | 3,251 | 17.5 | 0,050 | 85.0 |

Source: IDB, Annual Report. 1977, Tables No. V111 and 1X, P.17

* 91% of the approved loans has been granted during the period 1965 - 1977. See the above reference, P. 17

and progress of its clients, and to render advice on financial, managerial, and technical sides of their projects. At the same time, an information centre of various types of machinery and their manufacturers was established in the Bank, with the purpose of assisting local industrialists in choosing the most suitable machinery for their projects.(1)

Up to 1975, the activities of the IDB were mainly confined to financing large-scale industry and well-established enterprises able to give the necessary technical documentations and to provide the required collateral.(2) However, a development bank cannot ignore the essential needs of small-scale industries, especially in countries where these occupy an important part in the economy. This is the case in Jordan in which the manufacturing sector is composed mainly of small-scale industries and handicrafts. The number of large-scale establishments (employing over 100 each) accounted for 15, or only 0.2% of the total number of Jordanian industries.(3) Enterprises employing between five and ninety-nine persons were 580 in number, comprising 8.8% in relative importance of the total. Small-scale industries (those operating with less than four persons each) formed the dominant share of 91%, or a total of some 6,000 concerns. The development of the latter type of industry is particularly important from economic and social points of view, as was indicated by the Three Year Development Plan of 1973, which pointed out the essential needs of these types

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(1) Ibid.

(2) IBRD, Current Economic Position and Prospects of Jordan, op.cit. P.38

(3) For classification of employment according to size of industry, see: National Planning Council, Five Year Plan, 1976 - 1980, op.cit. P. 170

of industrialists, and the necessity of financing and promoting their activities.(1) The Plan recommended that a special Fund within the IDB should be established with an initial capital of JD 0.30 million to finance small-scale businesses against comparatively lower interest rates.(2) Following this recommendation, the Small-scale Industry and Handicrafts Fund was established within the IDB in 1975. By the end of 1977, the total number of loans approved by the Fund during its three years of operation accounted for 262, amounting to JD 0.41 million. The spread of credit among borrowers was clearly reflected in the average amount of loans which was noticeably less than that of the IDB. Table 8.11 reveals that the average size of the Fund's loans was JD 1,568 whereas that of the IDB accounted for JD 50,128.(3) Despite the high risk usually involved in lending to small-scale businesses, the repayment record of the Fund proved to be satisfactory and more successful than that of the IDB. Throughout its existence, the rate of collection of instalments fell due averaged 97% as compared with 85% for the IDB.

Although the amount of loans approved by the Fund accounted for only less than JD 0.50 million, nevertheless, the geographical distribution of loans and the comparatively large number of beneficiaries in different types of small concerns gave the fund's activity a special importance. Geographically, loans were distributed throughout the country as indicated by apppendix 8.3. Out of the 100 loans granted during 1977, 65 were extended in Amman, Zerka, Ajlun and Irbid, whereas the remainder were scattered in other towns. On the sectoral side, business-men in different domestic industries benefitted from the Fund's loans,

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(1) National Planning Council, Three Year Plan, 1973 - 1975, op.cit. P.120

(2) Ibid.

(3) See Table 8.10

with the major share going to carpentry, garments and knitting, and construction materials, which together absorbed three quarters of loans extended during 1977 (See Appendix 8.4).

Table 8.11 Loans Approved by Small-Scale Industry and Handicrafts Fund 1975 - 1977

| Year | No. of Loans | Approved Loans JD | Average Loans JD | Loans/ Recovery Ratio % |
|---|---|---|---|---|
| 1975 | 52 | 72,205 | 1,388 | n.a. |
| 1976 | 110 | 169,425 | 1,540 | 96.0 |
| 1977 | 100 | 169,200 | 1,692 | 99.0 |
| Total 1975 - 1977 | 262 | 410,830 | 1,568 | 97.0 |

Source: IDB, Annual Reports, 1975 - 1977

## II.3. Conclusions and Assessment of Specialised Credit in the Manufacturing Sector

The financial operations of the IDB have increasingly assisted and facilitated manufacturing growth. Although commercial banks continued to claim the lion's share of total institutional credit extended to manufacturing, Table 8.12 shows that specialised credit increased its relative importance from only 8.6% in 1965 to 28.8% by 1977. As was the case in the specialised agricultural credit, the significance of credit extended by the IDB was related to its long-term nature, which appropriately met the expansionary requirements of manufacturers. What made the IDB of special importance was the fact that up to December 1977, this institution represented the only institutional source for financing the long-term requirements of the manufacturing sector. Commercial

Table 8.12

## Relative Importance of Specialised Credit In Total Institutional Credit Extended to the Manufacturing Sector, 1965 - 1977

(In millions of J.D.)

| | 1965 | 1966 | 1967 | 1968 | 1969 | 1970 | 1971 | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | Average Ratio 1965-1977 % |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| A. Outstanding Manufacturing Credit | 4.74 | 5.62 | 5.62 | 5.62 | 6.03 | 7.07 | 7.10 | 7.39 | 9.30 | 14.45 | 20.64 | 30.01 | 37.68 | 100.0 |
| 1. Commercial Bank Credit | 4.33 | 4.75 | 4.25 | 4.02 | 4.20 | 4.76 | 4.59 | 4.65 | 6.26 | 10.46 | 15.11 | 22.14 | 26.83 | |
| 2. Specialised Credit | 0.41 | 0.87 | 1.37 | 1.60 | 1.83 | 2.31 | 2.51 | 2.74 | 3.04 | 3.99 | 5.53 | 7.87 | 10.85 | |
| (1) as a % of (A) | 91.4 | 84.5 | 75.6 | 71.5 | 69.7 | 67.3 | 64.6 | 62.9 | 67.3 | 72.4 | 73.2 | 73.8 | 71.2 | 72.7 |
| (2) as a % of (A) | 8.6 | 15.5 | 24.4 | 28.5 | 30.3 | 32.7 | 35.4 | 37.1 | 32.7 | 27.6 | 26.8 | 26.2 | 28.8 | 27.3 |
| B. Annual Volume of Specialised Loans disbursed by the IDB during the Development Plans' Period. | | | | | | | | | 0.77 | 1.32 | 2.06 | 3.01 | 3.72 | |
| | | | | | | | | | 4.15 | | | | | |
| C. Planned Investment in the Manufacturing Sector | | | | | | | | | 26.12 | | | 46.79 | 65.73 | |
| (B) as a % of (C) | | | | | | | | | 15.9 | | | 6.4 | 5.7 | |

Source: (1) For Commercial Bank Credit, See Appendix 4.5

(2) For Specialised Credit, See the IDB's Annual Reports.

(3) For the Figures of Planned Investment, see 3 Year Development Plan, op.cit. P.40 and the 5 Year Development Plan, op.cit. P.64

bank credit to this sector was confined to short-term loans. Moreover, a domestic capital market, through which enterprises could raise funds for long-term purposes, was only established in 1976 and began operations at the beginning of 1978.

The previous analysis has shown that the financial assistance rendered by the IDB was predominantly concentrated in the field of credit extension, and only a very small proportion of total finance (averaging around 4.9%) went in favour of equity financing. This situation was maintained, although the IDB's Law did not fix any restrictions on its ability to participate in the ownership of domestic industries. However, development banking experience showed that due to the comparatively higher risk involved in equity investment, this form of finance should not constitute the bulk of operations.(1) Development bankers do not, in general, advise that equity finance be made from borrowed funds; thus, a development bank should limit its ability to extend this type of assistance to the extent to which it has itself received equity capital.(2) When applying this recommendation to the Jordanian case, it became obvious that the amount of equity investment was still far from the ability of the IDB to finance equity, as measured by its capital capacity. By the end of 1977, equity financing comprised only 17% of the paid-in capital of the Bank. Clearly, this behaviour reflected a very cautious operational policy on the part of the IDB, leading to an extreme preference of safer cannons of finance available in the form of credit extension, rather than riskier operations in equity investment. The latter type of assistance has been increasingly demanded by businessmen to finance their expansion, after implementing successive development programmes. If it has to be properly a

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(1) Houk, Financing and Problems of Development Banks, op.cit. P.20

(2) Ibid.

development bank, the IDB should further undertake riskier business by channelling more resources towards equity financing. It may even launch a wider role in equity investment aiming at encouraging the private sector to invest their savings in equity holdings in different industries, in which the Bank has already an equity participation. Equity investment policy can be therefore made with a view to re-selling shares to domestic investors once public confidence in them has been established. The adoption of this type of policy seems to be an appropriate one, given the present economic situation in Jordan, for two reasons: firstly, the increase in the number of enterprises seeking capital as a result of implementing development programmes and, secondly, the utmost need for creating confidence in the recently established Amman Financial Market. Similar policies have been adopted by other development banks in developing countries where they had, sometimes, to even sell their most profitable investment after bearing the risk and cost of the development stage of the projects.(1)

A development bank can supplement its direct finance to manufacturing by ways and means which help these industries obtain funds from other sources. Although the IDB was empowered to issue its guarantees for credit extended for projects from other financing institutions, it has not so far shown any practical contribution towards guaranteeing business.(2) This type of activity has been quite substantial in some developing countries, such as Ghana, where its development bank's obligations under

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(1) Ghana is a case in point where equity investment was an active form of financing manufacturing. See: Harlander, H. and Mezger, D., Development Banking in Africa, Seven Case-Studies, (Munchen: Weltforum Verlag, 1971) P.69

(2) The IDB's annual reports, which usually reveal its activities, do not show any guarantee operations undertaken by the Bank.

guarantees exceeded the bank's total funds by some 30% to 60%.(1) Moreover, the IDB made a minimal contribution towards helping domestic industries to raise capital, by means of underwriting their shares and debts, or by assisting the development of a capital market. Through these channels, the IDB could have been more helpful in financing, though indirectly, the long-term requirements of various industries. These important aspects should take part in the future role of the IDB.

On the promotional side, the IDB has greatly assisted the technical efficiency of projects put before it, but at the same time, has shown little initiative in exploring and identifying suitable investment opportunities in the manufacturing sector taken as a whole. Financial assistance was only made after economic and technical feasibility studies were made by the Bank. Furthermore, the Bank, with the help of its follow-up division, also offered consulting services to the clients concerning different technical aspects of their projects. However, apart from the establishment of the information centre of various types of machinery (which operated to assist local manufacturers, clients and others in selecting suitable types of machinery), the IDB played only a limited role in promoting the general activity of the manufacturing sector. In other words, the IDB exhibited little interest towards conducting comprehensive pre-investment surveys aiming at identifying viable investment opportunities, either to develop them on its own, or to present them to domestic entrepreneurs. As was theoretically discussed, this aspect of development banking is very important in developing countries, such as Jordan, where the absence of adequate investment surveys further intensifies the reluctance of entrepreneurs to venture

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(1) Harlander and Mezger, op.cit. P. 79

into new lines of business. However, if the IDB has to enter this field, which is indeed necessary for a proper fulfillment of its developmental role, additional resources must be made available to the Bank. Given the expected high cost involved in such activities in relation to the expected long-term return, the Bank must be able to obtain funds, for this purpose, on easy terms through the Government, the Central Bank, and other international development institutions specialising in industrial financing.

In fact, additional resources for the Bank are also needed to enable it to meet the increasing demand made upon its services, particularly after implementing development programmes which largely emphasised the manufacturing sector. As has been repeatedly shown, one major aim of both the Three Year Plan and the Five Year Plan was to diversify the economy's industrial structure by strengthening its manufacturing sector; thus for this purpose, 15% of total investment of the former Plan was allocated to promote manufacturing industries, whereas this proportion was doubled as envisaged by the latter Plan.(1) Total financial assistance granted by the IDB was still limited as compared with the planned investment. As can be seen by Table 8.12, total financial assistance extended by the IDB formed 15.9% of the planned investment in the manufacturing sector during the period of the Three Year Plan, and about 6% of the planned investment as envisaged by the Five Year Plan during the first two years, ending in 1977. The IDB cannot expand its financial role unless it seeks a major increase in its resources. Apart from the private sector's contribution to the equity capital of the Bank, the latter showed no attempt to mobilise domestic savings for industrial financing. An

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(1) See Table 8.2

examination of the Bank's balance sheet of December 31, 1977,[1] revealed that 30% of its total financial resources came from capital and reserves, another 30% was financed by loans from the Central Bank, and a percentage of 36% represented loans from regional and international development institutions. The IDB can increase its financial capacity if it actively seeks other domestic sources of finance, by offering term deposits and issuing long-term industrial bonds. In so doing, the IDB can obtain further funds necessary for industrial financing, and, at the same time, can also institutionalise part of the community's savings, which could be otherwise held in unproductive forms.

Finally, the decision to establish the Small-Scale Industry and Handicrafts Fund within the IDB, as a response to the 1973 Plan, was essential to finance the needs of small businessmen who could not obtain credit elsewhere. The significance of this Fund was shown to be related to the widespread distribution of its credit on both the geographical as well as the sectoral side. The first three years experience of the Fund was encouraging, showing little risk in financing small concerns as reflected in a highly successful repayment record. However, because the Fund had only been newly established, and also because of its limited financial resources,[2] the number of borrowers benefiting from its loans throughout its existence comprised only 4.4% of the total number of small-scale concerns operating in the country.[3] Given this, together with the necessity of promoting this group of businessmen, from both the economic as well as the social point of view, further financial resources should be allocated to the Fund to enlarge its activities.

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(1) IDB, Annual Report, 1977 P. 28 and 29

(2) The Fund's capital accounted for only JD 0.32 million as of 31.12.1977.

(3) During the period 1975 - 1977, loans were extended to 242 borrowers, which formed 4.4% of the 6,000 small-scale industries, employing less than four persons each.

# III

## The Housing Sector

### III.1. The Need for Specialised Housing Credit.

Since its existence, Jordan has been faced with serious housing problems resulting from a particular combination of economic, social, as well as political factors.(1) Housing supply has always lagged behind demand. A high per annum natural population growth of 3.5%; the normal process of economic and social development which leads to a rise in the number of new independent households; and internal migration from rural areas to the cities where investment and job opportunities were becoming available, have all intensified the problem. These trends have been exacerbated by the compulsory migrations of Palestinians in the two wars of 1948 and 1967, which both put tremendous pressure on dwellings. The recent temporary immigration flow of Lebanese (particularly during 1976) following internal disturbances in their country also added to the housing crisis. This has been further intensified by a new source of demand emerging from the rural areas, aiming at improving the standard of rural housing which was no longer suitable for modern living. All these factors caused the demand for housing to considerably exceed the supply, especially the demand made by the low income groups.

Private investment in the housing sector was not sufficient to satisfy the increasing needs for housing. This was officially recognised as indicated, firstly, by the Seven Year Development Programme, 1964 - 1970. The Plan pointed out the lack of adequate financial facilities for housing financing, and recommended that a special financing institution had to be established to fill this gap.(2) Following this, the government finally decided to establish the Housing

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(1) Most of these factors were pointed out by the 5 Year Development Plan, 76 - 80, P.348

(2) Jordan Development Board, 7 Year Plan, op.cit. P.303

Corporation in 1965 to assist the private sector in financing housing needs. However, the creation of this institution did not solve the problem, and the gap between demand and supply still considerably existed. This was clearly pointed out by the Three Year Development Plan of 1973, which considered the absence of adequate credit available for housing purposes as the major factor contributing to the housing crisis.(1) To solve this problem, the Plan recommended the establishment of a government or a semi-government housing bank with adequate rsources to assist the development of the housing sector.(2) This manifested itself in the creation of the Housing Bank in 1974, which was the most recent as well as the biggest institution amongst the specialised banking sector.

III.2. Specialised Financial Intermediaries in the Housing Sector.

III.2.1. The Housing Corporation (HC)

Following the recommendation of the 7 Year Plan, the HC was established in 1965 as a semi-government institution, albeit with an independent status. The HC was the first lending institution specialising in financing the housing sector, with a particular emphasis being placed on accommodation for civil servants and people belonging to low and limited income groups. To achieve its objectives, Law No. 27 for 1968 empowered the HC to practise financial as well as promotional functions. Besides granting loans for housing construction, the HC can also prepare housing designs and conduct general surveys covering all aspects of housing activity.(3)

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(1) National Planning Council, Three Year Development Plan, op.cit. P.281

(2) Ibid. P.283.

(3) Law No. 27 of 1968 for the HC. Article IV.

The role of the HC has passed through four distinct phases of development. During the first few years of operation ending in 1968, the HC specialised in granting loans to individuals and housing co-operative societies. A total of 624 loans, amounting to JD 1.40 million, were granted for long-term periods reaching 15 years, against 5% simple interest. By 1968, however, the lending policy of the HC had changed to concentrate only on designing and implementing comprehensive housing projects to be distributed between beneficiaries on rental purchasing base. Loans were granted at 5% interest on a reduced balance basis, for periods reaching 20 years. This new policy was seen as a practical step towards the solution of the housing problem of the limited and low-income

Table 8.13 Loans Extended by the Housing Corporation, 1965-1976

| Year | Type of Loans | No. of House Units | Amounts of Loans (JD) | Average Loans (JD) |
|---|---|---|---|---|
| 1965-1968 | Individual and Housing Societies | 624 | 1,397,154 | 2,239 |
| 1969-1972 | Comprehensive Housing Projects | 660 | 1,207,000 | 1,829 |
| 1973-1975 | Comprehensive Housing Projects | 2,904 | 6,575,000 | 2,264 |
| 1976 | Comprehensive Housing Projects | 524 | 1,769,571 | 3,377 |
| Total 1965-1976 | | 4,712 | 10,948,725 | 2,324 |

Source: Housing Corporation, The Housing Problem in Jordan (June 1978) P. 27 and 28

groups by providing them with lower cost dwellings.(1) During this period, which extended to 1972, some 660 house units were distributed

(1) Housing Corporation, The Housing Problem in Jordan, (June 1978) P.28

with a value of JD 1.21 million. The third phase of development witnessed a noticeable increase in activities, accompanied by the Three Year Development Plan, 1973 - 1975. The Plan required the HC to continue its previous policy of providing comprehensive housing projects in different areas of the country. The total cost of the Planned investment during the Plan's period was estimated at JD 6.75 million.(1) Table 8.13 shows that the HC was able to implement 2,904 house units with a total cost of JD 6.58 million, a figure comprising 97% of the planned investment for the HC. Due to the continuous increasing demand for housing, the Five Year Plan of 1976 further required the HC to construct 7,500 housing units, having a total estimated cost of JD 25 million during the Plan's period.(2) Finance for these projects was envisaged to come from the HC's resources, as well as from other domestic and foreign sources. However, about half of the planned investment in these projects during the first year of the Plan (which was estimated at JD 3.83 million) was financed by the HC. As can be seen by the table, the HC provided 524 house units, costing JD 1.77 million during 1977. Thus, throughout its existence, the HC has extended 4,712 house units, with a total cost of JD 10.95 million.

Undoubtedly, the above lending activities which concentrated on accommodating the lower and limited income groups have given the HC a special significance from both the economic as well as the social points of view. However, due mainly to its limited financial resources, the HC was unable to meet the ever-increasing demand for housing. This was clearly indicated by the Three Year Plan which recommended the creation of the Housing Bank to assist housing development, by providing loans

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(1) National Planning Council, The Three Year Development Plan, 1973-1975, op.cit. P. 282

(2) National Planning Council, Five Year Development Plan, 1976 - 1980, op.cit. P. 353

to individuals, housing co-operatives, and also to the HC to help in achieving its objectives. Available statistics show that by 1977, the Housing Bank provided about 50% of the HC's total resources.(1) This gives some evidence to the significant role played by the Housing Bank in housing financing as will be shown in the following analysis.

III.2.2. The Housing Bank (HB)

The HB came into being in response to the recommendation of the Three Year Plan, with the purpose of solving the housing problem in Jordan. It was established as a public shareholding company in accordance with the special law which gave the HB large powers and facilities to practise its functions, much wider than those given to commercial banks and other private companies as shown in their respective Laws (i.e. the Banking Law and the Company Law). According to its Law, the HB was given some important concessions over private companies (including commercial banks) which helped it to expand rapidly during a short period of time. These concessions fell into two main categories. Firstly, unlike commercial banks and other private companies, all HB financial operations were exempted from any government tax or fees. This includes the exemption of the Bank's own profits, and interest paid on funds deposited with the Bank, from income tax. Secondly, the HB experienced a preferential treatment in government offices and departments, which were asked by law to give priority to the Bank to facilitate its operations. However, the special Law constituting the Bank has passed through successive amendments aiming at increasing its capital

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(1) Total HC resources at the end of 1977 were JD 16.00 million, of which half was financed by the Housing Bank, whereas the remaining 50% came from the following: 20% from the HC's inflow from repayments of instalments and interests; 16% from the annual government contribution; 10%from Central Bank Credit; and the rest of 4% represented loans from the Arab Fund for Economic and Social Development. See: HC, Housing Problem in Jordan, op.cit. P. 29

and expanding its activities. During four years of operations, the Law was amended five times, thus raising the Bank's authorised capital from only 0.50 million in 1973 to JD 18.00 million by 1977.*

The HB is unique amongst specialised banking institutions. Although the HB has an image of a specialised credit institution created for housing purposes, it is also active in many areas of commercial banking. It is the only specialised institution that accepts deposits from the public. An examination of the Table 8.14 reveals that, unlike other SCIs which relied heavily on their capital, deposits comprised the major source of funds for the HB, accounting for an average of 70.6% of total resources during the period 1974 - 1977. As a mobiliser of funds, the HB operated as any commercial bank offering a full range of account services, and accepting all types of deposits. Throughout four years of operations, HB deposits increased from only JD 3.17 million in 1974 to JD 36.75 million in 1977, an average rate of growth of 138% per annum. The HB was able to attract increasing proportions of deposits, which rose in relative importance of total resources from 60.8% to 66.9% between 1974 and 1977. The number of accounts rose tremendously from only 2,532 to 37,522 during the same period.(1) This occurred despite the stiff competition for deposits which the banking system experienced since 1973.(2)

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* The HB was established in accordance with the Temporary Law No. 41 of 1973, which fixed its capital at JD 0.50 million. This was soon amended by Temporary Law No. 48 of 1973 which raised its capital to JD 1.00 million. The permanent Law of the Bank was issued in April 1974 which increased its capital to JD 2.00 million, divided into 2.00 million shares. The Permanent Law was under further amendments by three temporary laws no. 14 for 1975; No. 49 for 1975; and No. 8 for 1977. The first amending law raised the authorised capital of the Bank to JD 12.00; the second aimed at expanding its activities; and the latter further increased its authorised capital to JD 18.00 million. (See: Housing Bank, Annual Reports of 1975, P.28 & 30; and 1977, P.15.)

(1) See Appendix 8.5

(2) See Chapter 5, PP. 155 - 161

Table 8.14

## Sources of Funds of the Housing Bank, 1974 - 1977

(In Millions of JD)

| Year | Capital | | | | | | | | Reserves | | Deposits | | CBJ's Advances | | Others | | Total Funds | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Govt. & CBJ | | Private Sector* | | Overseas Investors** | | Total | | | | | | | | | | | |
| | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % |
| 1974 | 1.00 | 19.1 | 1.00 | 19.1 | - | - | 2.00 | 38.2 | 0.02 | 0.5 | 3.17 | 60.8 | - | - | 0.03 | 0.5 | 5.22 | 100.0 |
| 1975 | 1.00 | 7.7 | 1.00 | 7.7 | - | - | 2.00 | 15.4 | 0.07 | 0.5 | 10.85 | 83.6 | - | - | 0.06 | 0.5 | 12.98 | 100.0 |
| 1976 | 1.00 | 3.1 | 1.00 | 3.1 | 4.00 | 12.5 | 6.00 | 18.7 | 0.53 | 1.7 | 22.79 | 71.0 | 2.33 | 7.2 | 0.45 | 1.4 | 32.10 | 100.0 |
| 1977 | 1.00 | 1.9 | 3.26 | 5.9 | 6.00 | 10.9 | 10.26 | 18.7 | 1.61 | 2.9 | 36.75 | 66.9 | 5.51 | 10.1 | 0.72 | 1.4 | 54.95 | 100.0 |
| Average %, 74 - 77 | | 7.9 | | 9.0 | | 5.8 | | 22.7 | | 1.4 | | 70.6 | | 4.3 | | 1.0 | | 100.0 |

Source: Housing Bank, Annual Reports, 1975 - 1977

* Includes some foreign individuals which accounted for 17% of the private sector's share in 1977.

** Overseas Governments and regional investment institutions.

The success of the HB in mobilising funds can be attributed to branch expansionist policy and other innovative techniques which were introduced to the system for the first time. As far as the network of branches was concerned, the Bank expanded its activities into geographical areas which were either inadequately covered by commercial banks or which were not served by any bank at all. By operating in areas where no banking competition existed before (such as Tafileh which was previously served exclusively by the Jordanian National Bank) and by establishing a branch in Fuhais (where no other bank existed), the HB has undoubtedly expanded the national market for banking services and, at the same time, increased its relative share in the banking system.(1) Moreover, the Bank introduced a new method for extending its services to rural areas which were still too small to justify the establishment of a permanent branch. A "mobile" branch operated in such areas to acquaint people there with bank services, and to provide them with ordinary banking facilities. These branches benefited from the premises of village councils, which were used as temporary locations for conducting their operations.(2) Clearly, this innovation widened the geographical coverage of bank networks, thus attracting new customers into the banking field. However, the widespread geographical distribution of HB branches is evident by Appendix 8.5, which reveals that the number of branches were more than tripled between 1974 and 1977, with the largest share going to areas outside Amman. Out of the 15 branches existing in 1977, 11 were situated outside the Capital. The relative share of Amman's branches decreased over time, declining from 60% in 1974 to only 26% by 1977.

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(1) Jordan Times (Amman: Sunday, March 19, 1978) P. IV

(2) Housing Bank, Annual Report, 1975, P.51

Branch expansionist policy was supplemented by the introduction of some innovative techniques aiming at encouraging the growth of deposits. Besides offering competitive interest reaching 5¼% on saving deposits, the HB ran, for the first time in the country's banking history, a lottery on savings accounts. Two draws of the lottery were held during 1977, with a total value of JD 20,000.(1) As a result, the relative importance of this type of deposit within the deposits mix rose from 13% in 1976 to 24% in 1977.(2) Another innovation introduced by the Bank was in the form of extending work hours in the afternoon, which provided considerable convenience for government employees who worked during normal banking time. As compared with the rest of commercial banks which operated till 2.00 p.m., the HB extended its services in many branches till 5;00 in winter and 6:0 in summer months.(3) Clearly, such innovations, together with the grographical expansion of branches, led to a continuous rise in deposits to form the major source of HB resources.

After deposits, paid-up capital constituted an important source of funds, comprising an average proportion of 22.7% of total resources. HB capital underwent successive increases throughout the period under review. It was initially established by an authorised capital of only JD 0.50 million, which was exclusively subscribed by the government and the Central Bank. This was successively increased to reach JD 18.00 million by 1977, of which JD 10.26 million was fully paid-up. JD1. million of the paid-up capital was equally subscribed by the government and the Central Bank;

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(1) HB, Report of the Board of Directors For Financial Year Ending 31.12.1977. P.12.

(2) See Table 8.18.

(3) Jordan Times, op.cit. P.III.

JD 6.00 million was subscribed by Oil-Producing Countries; and the balance of JD 3.26 million was held by the private sector, predominantly Jordanian. These figures illustrate the success of the HB in mobilising overseas funds in the form of equity capital. As Table 8.14 demonstrates, overseas capital contributed by at least one tenth to total bank resources in 1977.(1)

As far as use of funds is concerned, the pattern of resource allocation clarified the role of the HB as a specialised institution for housing purposes. In contrast to ordinary commercial banks, the HB allocated a lower proportion of its resources to liquid assets. As was shown earlier, the HB operated under a special law and was not, therefore, subject to the Banking Law, which forced the banks to maintain a minimum liquidity ratio. However, Table 8.15 shows that liquid assets held by the HB experienced considerable change between 1974 and 1977, declining in relative importance from a high level of 79.3% of total assets to only 14.8%. The Bank was very liquid in 1974 because it just commenced its operations; but once it established itself, it began to divert more resources towards promoting housing activities. This took the following three different forms of assistance which all aimed at solving the country's housing problem:-

(1) <u>Lending Activities</u>. Credit extension formed the bulk of HB's operations, absorbing 78.2% of total resources in 1977, as compared with only 18.6% in 1974. During the first years of operations, credit was granted only to individuals and housing co-operative societies. With a continuous rise in its resources, the Bank sought an amendment in its law aiming at expanding its activities into new lines of business. The

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(1) As explained by Table 8.14, about 17% of the private sector's equity share in 1977 were non-Jordanian. This represented 1% of total Bank resources. If this is added to the 10.9% representing overseas government subscription, the total overseas contribution to equity capital becomes exactly 11.9% of total resources of HB.

Table 8.15

## Uses of Funds of the Housing Bank, 1974 - 1977

(In million of JD)

| Year | Liquid Assets | | Housing Loans | | | | | | | | | | Equity Investment | | Real Estate Investment | | Fixed Assets* | | Total Assets | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | Personal | | Co-op. Housing Funds | | Commercial Loans | | Local Minist. & Admin. Offices | | Total | | | | | | | | | |
| | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % |
| 1974 | 4.14 | 79.3 | 0.85 | 16.3 | 0.12 | 2.3 | - | - | - | - | 0.97 | 18.6 | 0.03 | 0.6 | - | - | 0.08 | 1.5 | 5.22 | 100.0 |
| 1975 | 6.95 | 53.5 | 4.48 | 34.5 | 0.22 | 1.7 | 0.61 | 4.7 | - | - | 5.31 | 40.9 | 0.13 | 1.0 | - | - | 0.59 | 4.6 | 12.98 | 100.0 |
| 1976 | 6.82 | 21.2 | 12.40 | 38.6 | 1.47 | 4.6 | 5.31 | 16.5 | 4.17 | 13.0 | 23.35 | 72.7 | 0.55 | 1.7 | 0.89 | 2.8 | 0.49 | 1.6 | 32.10 | 100.0 |
| 1977 | 8.12 | 14.8 | 19.27 | 35.1 | 2.67 | 4.9 | 9.90 | 18.0 | 11.12 | 20.2 | 42.96 | 78.2 | 1.18 | 2.1 | 1.63 | 3.0 | 1.06 | 1.9 | 54.95 | 100.0 |
| Average %, 74 - 77 | | 42.2 | | 31.1 | | 3.4 | | 9.8 | | 8.3 | | 52.6 | | 1.4 | | 1.4 | | 2.4 | | 100.0 |

Source: Housing Bank, Annual Reports, 1975 - 1977

* Includes other items.

Temporary Law No. 49 of 1975 enabled the Bank to extend loans for commercial purposes, and also to invest in the equity capital of companies operating in construction industry. Starting in 1976, moreover, the HB expanded its credit to cover the public sector. As can be seen by Table 8.15, loans extended to local ministries accounted for 13% of HB resources in 1970, and further increased to 20.2% by 1977. Personal loans, however, continued to claim the predominant share, forming 31.1% of total resources.

In extending credit, HB followed a preferential policy favouring loans extended to individuals and co-operative housing funds, as distinct from loans granted for commercial and investment purposes.(1) Since one objective of the HB was to encourage the creation of co-operative housing societies which could provide low-cost housing,(2) this type of borrower was given further preferential treatment. In addition to the priority given to these societies, loans were extended against comparatively lower interest rates ranging between 7% and 7½%, depending on the maturity of loans which reached 20 years. Loans extended to individuals for housing purpose came second in the preference scale, with interest rates ranging from 7½% to 8½%, varying with the maturity of loans which reached 20 years. On the other hand, commercial loans were granted only for a maximum period of 5 years, and against higher interest rates of 9% plus 1% commission. However, when granting individual loans, the HB required the borrower to own the land or the building for which the loan was given. These loans were extended with a maximum ceiling of JD 7,000 on the basis that instalments should not exceed one third of the borrower's steady monthly income. Furthermore, the HB asked for real estate or other tangible securities as collateral for loans. In all cases, a particular emphasis was placed on the ability to repay the loans from the borrower's future income.

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(1) For the preferential lending policy of the HB, See HB Annual Report, 1974, PP. 36-38.

(2) HB Law No. 4 for 1974, Article 6-C.

Table 8.16 shows the importance of the HB's loan activity in alleviating the country's housing problem. Throughout four years of operations, loans issued by the HB accounted for 8,297, with a total value of JD 58.90 million. This assisted in establishing 15,851 housing units, with a total area of about two million sq. meters. The repayment record of the HB has been very successful - loans recovery ratio averaged around 99.9%, an indication of sound lending policies adopted by the Bank. From its inception, the HB extended its activities to meet the need for housing credit throughout the country. However, due to the concentration of the housing problem in the Amman Area, this region claimed the lion's share in total credit, absorbing an average of 70% during the period under review. Following in relative importance, as shown by Appendix 8.6, were Irbid and Zerka which claimed 7.8% and 7.4% respectively. The relatively higher share of these two cities, as compared with the remaining regions, was a clear reflection of the increasing pressure on housing to accommodate larger part of population concentrated there.

Table 8.16. Loan Activities of the Housing Bank, 1974 - 1977.

| Year | No. of Loans | No. of Financed Units | Amounts of Loans (m JD) | Financed Area (thou $m^2$) | Loans Recovery Ratio % |
|---|---|---|---|---|---|
| 1974 | 718 | 762 | 1.8 | 101 | n.a. |
| 1975 | 2,092 | 2,774 | 8.6 | 392 | 99.9 |
| 1976 | 3,078 | 8,006 | 33.1 | 973 | 99.9 |
| 1977 | 2,409 | 4,309 | 15.4 | 510 | 99.9 |
| Total 1974-1977 | 8,297 | 15,851 | 58.9 | 1976 | 99.9 |

Source: Housing Bank, Report of the Board of Directors for financial Year ending 31/12/77. Table 3

(2) Equity Investment. The HB has quickly moved from purely credit-creating activities to that of investment banking. The amendments of temporary laws No. 49 for 1975 and No. 8 for 1977 enabled the Bank to participate in the equity capital of domestic enterprises with close connection to construction industry, in particular, and to the general development of the economy in general.(1) This was seen by the HB as a necessary step towards combating inflationary pressures that could follow a generous extention of loans without a corresponding rise in the production of building materials.(2) Moreover, equity investment was viewed as an appropriate channel for assisting general economic development and, at the same time, achieving suitable profits to shareholders.(3) However, although a small proportion of HB resources were directed into equity financing, Table 8.15 reveals that this type of investment was gaining in importance during 1974-1977, rising from only 0.6% to 2.1%. By 1977, HB paid-up equity investment accounted for JD 1.2 million distributed between 10 different domestic companies operating in construction, manufacturing, as well as financial fields.(4) More than half of this investment was made during 1977, which witnessed the creation of new enterprises within the framework of the 5 Year Plan. In so doing, the HB has directly assisted the establishment of these enterprises, and also promoted the purchase of their equity by the private sector after giving them the public confidence.

(3) Direct Investment in Real Estate Projects. Financed completely by the HB, a major project of real estate investment with a total cost of JD 8 million has been undertaken since April, 1976.(5) The project comprised

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(1) HB, Law No. 4 for 1974, Article 7.H.

(2) HB, Annual Report, 1977, P.37.

(3) Ibid.

(4) Ibid. P.36.

(5) Ibid. P.39.

a huge commercial complex covering a floor area of 80,000 sq. meters. The estimated income from this project, which is expected to be ready by 1980, is JD 2 million per annum. In addition to this investment, the HB rented three floors of its own new building which has been used as a main office since 1977. The rent returned to the Bank an annual income of 9% of the total cost of the building. However, direct investment in real estate projects still comprised only a small proportion of total resources not exceeding 3% by 1977 (See Table 8.15).

III.3. Conclusions and Assessment of Specialised Housing Credit.

Given the unique feature of the HB as a mobiliser of funds, besides its specialisation in housing financing, it is necessary first to assess the extent to which the Bank has been successful in institutionalising savings, before assessing its contribution (together with the HC) to the solution of the country's housing crisis. Part A of Table 8.17 demonstrates the success of the Bank in attracting deposits as measured, firstly, by the steady increase in its relative importance in total deposits held by the banking system and, secondly, by a higher annual growth rate of its deposits as compared with that of commercial banks. The HB has steadily increased its relative share in total banking deposits, rising from only 2.8% in 1974 to 11.5% by 1977. HB deposits, moreover, increased rapidly at an average annual rate of 138%, whereas commercial banks' deposits grew at a slower rate of 35% throughout the same period. As indicated earlier, this success can be attributed to branch expansionist policy, together with some innovative methods which were employed by the HB.

However, such an active mobilisation role played by the HB must have influenced the liquidity position of the private sector. Item 5 of the same Table shows that deposits held by the HB increasingly contributed to the private sector's liquidity (Money Supply widely defined), rising

Table 8.17 The Relative Importance of HC and HB Activities, 1974-1977.

(In millions of JD)

| | | 1974 | 1975 | 1976 | 1977 | Average Annual %, 74-77 |
|---|---|---|---|---|---|---|
| A. | 1. HB deposits | 3.17 | 10.85 | 22.79 | 36.75 | |
| | 2. Commercial Banks' deposits | 111.98 | 158.04 | 227.24 | 283.81 | |
| | 3. Total Deposits | 115.15 | 168.89 | 250.03 | 320.56 | |
| | (1) as % of (3) | 2.8 | 6.4 | 9.1 | 11.5 | 7.5 |
| | Average Annual Growth Rate of (1) | - | 242.3 | 110.0 | 61.2 | 138.0 |
| | Average Annual Growth Rate of (2) | 30.5 | 41.1 | 43.8 | 24.9 | 35.1 |
| | 4. M2 (M1 + Quasi Money) | 216.74 | 277.75 | 358.92 | 438.99 | |
| | 5. (1) as a % of (4) | 1.5 | 3.9 | 6.3 | 8.4 | 5.0 |
| B. | 4. Specialised Housing Credit | 3.80 | 7.75 | 25.69 | 45.73 | |
| | 4.1. HC | 2.83 | 2.44 | 2.34 | 2.77 | |
| | 4.2. HB | 0.97 | 5.31 | 23.35 | 42.96 | |
| | 5. Commercial Banks' Housing Credit | 18.84 | 26.28 | 30.86 | 33.83 | |
| | 6. Total Housing Credit* | 22.64 | 34.03 | 56.55 | 79.56 | |
| | (4) as % of (6) | 16.8 | 22.8 | 45.4 | 57.5 | 35.5 |
| | (4.1) as % of (6) | 12.5 | 7.2 | 4.1 | 3.5 | 6.8 |
| | (4.2) as % of (6) | 4.3 | 15.6 | 41.3 | 54.0 | 28.7 |
| C. | % of Loans granted by HB to planned credit** | | | 425.0 | 181.8 | 303.4 |

Source: (1) Central Bank of Jordan, Monthly Statistical Bulletin, (June 1978) Table No. 11, 12 and 17.

(2) National Planning Council, 5 Year Plan, op.cit. P.360.

* Loans outstanding at the end of the period.

** Ratio of Loans disbursed during each year to planned investment for the HB as envisaged by the 5 Year Development Plan. The Plan envisaged that half of the private sector's planned investment in the housing sector during the Plan's period should be financed by the HB. See: 5 Year Development Plan, op.cit. P.354 & 360.

in relative importance from only 1.5% in 1974 to 8.4% by 1977. This situation must draw the attention of the Central Bank to the possible impact of HB operations on the effectiveness of pursuing domestic monetary policy, which has been so far confined only to commercial banks' activities. It was shown that the HB operated under a special law excluding its operations from banking control regulations. If the HB maintains its distinct rapid growth whereas it continues to be out of monetary control, future monetary actions might be frustrated. The Central Bank should deliberately study such effects which may require subjecting this unique institution to some kind of central control.

On the allocation side, specialised housing credit (extended by both the HB and the HC) has undoubtedly financed a large part of the country's housing needs. As is shown in Part B of Table 8.17, this type of credit increased its relative importance in total institutional finance available in the housing sector from only 16.8% in 1974 to 57.5% by 1977. The remaining percentage was furnished by commercial banks. The rise in the relative role of specialised credit came from the HB side rather than the HC's. Whereas the relative share of the latter declined from 12.5% to 3.5% during the period under review, the former rose in relative importance to reach 54% by 1977 as compared with only 4.3% in 1974. Such a tremendous rise in the relative share of the HB was attributed to generous lending policies adopted by its management. This can be evident by comparing the volume of loans disbursed by the HB with its planned financial role as envisaged by the Five Year Plan. Part C of the same Table shows that during the first two years of the Plan's period, actual achievements of the HB in relation to its planned investment averaged around 303%.

However, this does not necessarily mean that by such generosity the HB has properly contributed to the solution of the country's housing problem,because this problem also has a qualitative dimension. Given the reasons behind the housing crisis in Jordan (emanating mainly from

the influx of refugees and displaced persons together with voluntarily internal migration from villages to cities), the problem has been particularly great for people belonging to the low and middle-income groups. This fact was clearly illustrated by a recent study prepared by the HC which estimated the need for housing during the coming 10 years, ending in 1986.(1) According to this study, about 53% of the country's housing needs was estimated to be required for accommodating people belonging to low-income group, 25% for middle-income group, and the remaining 22% for meeting the housing needs for the higher-income group. However, given the operational lending policy of the HB, which required the borrower to own land or buildings as a pre-requisite for obtaining a loan, it appeared that about half of Jordanian households belonging to low-income groups (in which the need for housing was highly concentrated) had been hardly touched by HB services. With an annual income not exceeding JD 600,(2) a Jordanian household belonging to this group would find it almost impossible to buy land or to own a building in order to be an eligible borrower from the Bank. HB lending operations were in fact directed towards certain categories of population belonging to middle and higher-income groups, who could satisfy the necessary conditions for obtaining loans. Moreover, large proportions of credit extended were not used for borrower's own housing needs, but largely utilised for renting and other commercial and investment purposes. Although this undoubtedly satisfied specific needs for housing, which were further intensified with the sudden influx of Lebanese particularly during 1976, the essential needs of lower-income groups and a large part of the middle-income group were still inadequately met. One main result of this situation was that

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(1) Housing Corporation, The Housing Problem in Jordan, op.cit. P.13.

(2) According to the HC estimation, 50% of Jordanian households belong to the low-income group, with total annual earnings not exceeding JD 600. See Ibid. P.12.

HB operations indirectly widened the economic and social differences amongst Jordanians.

It can also be said that the generosity with which the HB poured money into construction activities has unwittingly intensified inflationary pressures. The HB started operations at a time when the supply of factors of production to the construction sector, particularly labour, far from satisfied demand. The market already experienced a shortage of manpower, as a result of emigration following the higher wages offered in the neighbouring Arab Oil-Producing Countries. The generous lending approach adopted by the HB intensified this shortage, with the resultant sharp rise in labour wages. At the same time, domestic industries producing building materials were also unable to satisfy the rising demand on their production, thus leading to a considerable increase in prices.(1) However, as was shown earlier, the HB tried to alleviate this problem by directing its investment policy towards equity financing of domestic enterprises producing building materials.

Another criticism which can be levelled against the HB rose from the analysis of its financial structure. An examination of the maturity structure in both sides of the balance sheet reveals a lack of co-ordination and matching between the composition of deposits (which constitute the major source of funds) and the maturity of loans extended (which comprise the main channel of investment). By 1977, for example, current deposits (payable on demand) accounted for 62% of total deposits. Saving deposits came second in importance with a relative share of 24%. These deposits were of a similar nature to demand deposits since they could be also withdrawn at any time.(2) Thus, the relative proportion of deposits which were

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(1) Between 1975 and 1977, for example, the wholesale prices of Cement, Iron Bars, Window Glass Sheets, and Clay Tubes increased by 55%, 14%, 150%, and 150% respectively. See Housing Corporation, The Housing Problem in Jordan, op.cit. P.37.

(2) Housing Bank, Annual Report, 1977, op.cit. P.23.

payable on demand comprised 86% as of December 31, 1977. The remaining 14% formed term deposits held for certain maturities. However, the weak position of term deposits in the deposit mix was accompanied, on the assets side, by a loan portfolio with distinctly longer maturity. Table 8.18 reveals that 62% of loans outstanding at the end of 1977 had long-term maturities ranging between 5 to 15 years, whereas the remaining percentage of 38% represented medium-term loans granted for periods of up to 5 years. Although this test is only a crude measure to assess the financial structure of the HB,[1] nevertheless, it clearly points out that maturities between the major components of assets and liabilities have not been precisely matched.[2] Deposits contributed to toal resources by 66.9% in 1977 whereas, on the other hand, housing loans of medium and long-term maturities absorbed 78.2% of total resources in the same year. Another 5% of HB's resources was utilised for long-term finance in the form of equity participation and real estate investment. Although a large part of long-term assets must have relied on the substantial paid up capital (which contributed to toal resources by 18.7%), nevertheless, the HB should have relied more on term deposits, which were necessary to match its pattern of lending. When the question of poor matching maturities between deposits and loans was raised during an interview with a senior official at the HB, the answer forthcoming was that the Bank had always had a sound financial position and had never experienced any financial difficulty. He added that even if there will be any financial embarrassment in the future resulting from a sudden nervousness on the part of the public, the HB will be safe because all its liabilities towards other parties are

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(1) A proper assessment requires a close examination of the inflow of instalments and the general cash flow of the Bank, which are not at the disposal of the study.

(2) There may well be good practical reasons for this, e.g. building societies in Britain have traditionally been able to finance their activities relying on the fact that their demand deposits are not usually subject to rapid general withdrawal. However, due to the relatively unstable economic and political environment prevailing in developing countries, short-term deposits cannot be largely relied upon for extending long-term housing credit.

Table 8.18 Composition of Deposits and the Maturity Structure of Loans Extended by the HB, 1974 - 1977.

%

| Year | Type of Deposit | | | | | Maturity of Loans | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Current | Saving | Notice | Time | Total | 1-5 Years | 5-10 Years | 10-15 Years | Total |
| 1974 | 58 | 8 | 8 | 26 | 100 | 13 | 35 | 52 | 100 |
| 1975 | 70 | 9 | 8 | 13 | 100 | 36 | 31 | 33 | 100 |
| 1976 | 73 | 13 | 6 | 8 | 100 | 30 | 54 | 16 | 100 |
| 1977 | 62 | 24 | 6 | 8 | 100 | 38 | 33 | 29 | 100 |
| Average Percentage 1974-1977 | 66 | 14 | 7 | 13 | 100 | 29 | 38 | 33 | 100 |

Source: Housing Bank, Report of the Board of Directors For Financial Year Ending 31.12.77, Tables No. 1 & 2.

completely guaranteed by the government.(1) However, the operational history of the HB has still been short. The maturity of the main assets and liabilities should be properly matched. It is the author's belief that, as a housing bank specialising in granting medium and long-term loans, the HB should considerably increase the relative weight of term deposits in the deposit structure. The enthusiasm by which the HB has been operating (which was largely encouraged by concessions and guarantees provided by the government) should not engulf it in future financial difficulties.

Finally, it can be concluded that despite the recent increase in the HC activities and the establishment of the HB, the housing problem still existed as revealed by both the 5 Year Plan and the HB itself.(2) Housing

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(1) Article 17 of the HB Law No. 4 for 1974 States this fact.

(2) See 5 Year Plan, P.348 and HB, Annual Report of 1977, P.25.

supply has still been lagging behind demand. The gap was even widened for people belonging to lower- and middle-income groups, whose opportunities for meeting their housing needs were minimised, given higher construction costs resulting from rising inflationary pressures and land speculation. This situation requires further financial support to the HC to increase its ability of providing comprehensive housing projects, with lower construction costs, for the benefit of lower- and limited-income groups.

## IV

## Municipal & Village Councils' Sector

### IV.1. The Need for Specialised Credit.

The natural process of socio-economic development faced local government (municipals and village councils) with increasing pressures on essential public services in the field of education, electricity, water supply, and other public utilities. At the municipal level, the continuing influx from rural areas to the cities, with economic development projects concentrated there, together with the sudden increase in population as a result of the 1948 and 1967 wars, have greatly intensified the need for such services. At the village level, the need for continuous modernisation of the rural community, and the necessity of implementing development projects to counteract internal immigration to the cities, have assumed large expenditure by the village councils. Local resources for both municipal and village councils were small in relation to their assumed development responsibilities. Due to the long-term nature of these needs, and the high risk involved, commercial banks were usually reluctant to extend credit to this sector. There was, therefore, an essential need for an official intervention to create a specialised institution for assisting local governments in connecting various regions of the country with adequate network of necessary services.

## IV.2. Financial Intermediaries in the Municipal & Village Councils' Sector.

### VI.2.1. Municipal and Village Loans Fund (MVLF)

Prior to the establishment of the MVLF in 1966, loans to municipalities were provided by the Municipal Loan Fund which operated within the Jordan Development Board; whereas village councils received credit from the Village Loan Fund which was administered by the Agricultural Credit Corporation.(1) The 7 Year Plan of 1964 revealed that both Funds operated with very limited financial resources which prevented them from adequately fulfilling their role.(2) The Plan, therefore, recommended the amalgamation of the two agencies in one autonomous specialised institution, capable of providing further assistance to local governments. The MVLF was thus established with government share capital of JD 1.76 million.(3) The Government further increased its equity financing to reach, by 1977, 55% of total capital of JD 4.90 million, the remaining percentage comprising net profits accrued to the Fund throughout its existence.(4)

Table 8.19 shows the scope of MVLF activities during the period 1967-1977. Loans were extended to local governments to help in financing development projects within their areas. Village councils were given preferential treatment over municipalities, in terms of maturity of loans and interest rates. Whereas the maximum period of loans extended to the former reached 15 years with interest of 4½%, the latter received credit for shorter maturities, not exceeding 10 years, against higher interest rate of 5½%.(5) Throughout 11 years of operations, the Fund granted 1047 loans for financing essential services. Classified according

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(1) MVLF, Achievements During 1966-1976, (Amman: MVLF, In Arabic) P.9.

(2) Jordan Development Board, 7 Year Plan, op.cit. P.358.

(3) MVLF, Annual Report, 1977, P.10.

(4) Ibid.

(5) MVLF, Annual Report, 1977, P.12.

Table 8.19 Lending Activities of the Municipal & Village Loan Fund, 1967 - 1977.

| Year | No. of Loans (1) | Value of Loans (JD'000) | | | | | | | | | | Planned Invest. in Municipal & Rural Sector (3) | % of (2) to (3) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Electricity | | Water Supply | | Education | | Public Utilities | | Total (2) | | | |
| | | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | | |
| Total 67-72 | 293 | 0,723 | 17.6 | 1,301 | 31.3 | 0,454 | 10.9 | 1,671 | 40.2 | 4,153 | 100.0 | - | - |
| Total 73-75 | 421 | 0,614 | 17.5 | 0,512 | 14.6 | 1,297 | 37.1 | 1,077 | 30.8 | 3,500 | 100.0 | 14,758 | 23.7 |
| Total 76-77 | 333 | 0,456 | 12.2 | 0,329 | 8.8 | 1,121 | 30.0 | 1,831 | 49.0 | 3,737 | 100.0 | 15,505 | 24.1 |
| Grand Total 67-77 | 1047 | 1,797 | 15.8 | 2,142 | 18.8 | 2,872 | 25.2 | 4,579 | 40.2 | 11,390 | 100.0 | | |

Source: (1) MVLF, Achievements During 66-76, op.cit.
(2) ____, Second Annual Report, 1977.
(3) National Planning Council, Three Year Plan, op.cit. P.308.
(4) _____, Five Year Plan, op.cit. P.379.

to purpose, public utilities absorbed the lion's share of total loans, comprising an average ratio of 40.2%. Educational activities came second in importance, with a relative share of 25.2%. The remaining percentages of 18.8% and 15.8% were utilised for financing water supply and electricity projects.

Clearly, the provision of such services was a pre-requisite for attaining economic progress. Given this fact, special emphasis was placed by the Government on the development of municipal and rural affairs within its comprehensive economic and social development programmes. This sector accounted for 8.2% of the total investment of the Three Year Plan of 1973 and 5.1% of the Five Year Plan of 1976. As is shown below, only a small proportion of the planned investment was financed by the MVLF.

IV.3. Conclusions and Assessment of Specialised Credit in the Municipal & Village Councils' Sector.

The MVLF was not in fact an adequate instrument for financing and promoting the enormous development needs of local governments. It largely restricted its assistance to credit extension, showing little contribution towards the provision of technical and advisory services. Even the credit provided by the Fund was insufficient to finance various development projects of municipalities and villages.(1) The same table shows that only less than one quarter of the planned investment of both development plans was financed by the MVLF. This was mainly due to a lack of sufficient resources available for the Fund which restricted its ability to extend further credit. The MVLF relied exclusively on funds provided by the Government, the Central Bank, and other concerned regional and international development agencies. An examination of MVLF balance sheet

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(1) MVLF, Achievements During 1966-1976, op.cit. P.36.

of 1977 reveals that the above three sources of funds provided the bulk of financial resources, with respective relative shares of 25%, 40%, and 17%.(1) The Fund showed no attempt to enlarge its financial capacity by attracting private sector's savings, in the form of issuing long-term development bonds which could be guaranteed by the government. Thus, the ability of the MVLF to extend loans was automatically dependent on the extent to which it received official financial assistance itself.

On the promotional side, the performance of the MVLF in providing technical assistance and other advisory services was unsatisfactory. This institution was not in fact equipped with the necessary machinery capable of rendering this service. Its operations were characterised by excessive government beaurocracy. There was an obvious lack of qualified personnel and technical staff which could move the Fund towards a proper development institution. The Five Year Plan pointed out the weak technical machinery attached to the Fund, asking the Central Bank of Jordan and the National Planning Council to study the possibility of re-organising this institution, so as to enhance its effectiveness in promoting urban and rural developments.(2) Following this recommendation, a study was initiated with the help of the World Bank expertise to replace the MVLF by a new independent specialised credit institution, capable of providing further assistance to local governments.(3) The study, which is still under preparation, is likely to propose a new name for the new institution, "The Municipal and Rural Development Bank", which it is envisaged will concern itself more with proper development banking. The proposed institution will be

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(1) The remaining percentage was mainly financed by accumulative net profits of the Fund. See: MVLF, Annual Report, 1977, op.cit. P.10&11.

(2) National Planning Council, Five Year Development Plan, 1976-1980, op.cit. P.367.

(3) MVLF, "Sector Notes", Unpublished Study (1978) P.2.

supplemented by greater financial resources and equipped with dynamic technical machinery and research facilities.(1) It will seek to render further assistance to urban and rural areas by, firstly, financing basic social services (such as education, public utilities, etc.) and, then, by implementing income generating projects to improve the living standards. Such an institution will also provide the required technical assistance and advisory services to its clients. If the above services are actually undertaken by the new institution, the existing financial as well as technical gaps in this sector will be greatly reduced.

Having analysed and assessed the operations of the six specialised credit institutions operating in the country, the next Chapter will deal with contractual financial institutions and the Postal Saving Fund.

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(1) Ibid. P.9.

# CHAPTER 9

## THE CONTRACTUAL FINANCIAL INTERMEDIARIES AND THE POSTAL SAVING FUND

The supply-leading pattern of evolution was not only confined to the already discussed SC1s, but it also characterised the evolution of other financial institutions with different specialisations. Apart from insurance companies which were privately initiated, the remaining NBFIs covered in this and in the following chapters were deliberately created and assisted by the government to perform specialised financial functions. However, whether their creation was justified by internal economic and financial needs, and the extent to which such institutions performed their assigned developmental role need to be examined. This chapter covers contractual saving institutions (i.e. insurance companies and pension funds) together with the Postal Saving Fund, whereas the following chapter is concerned with the recently established Amman Financial Market.

However, it is important to state at the outset that the analysis of the role of the financial intermediaries covered in this and in the following chapters is largely constrained by two factors. Firstly, the lack of adequate published statistics pertaining to activities of some intermediaries, namely insurance companies. Although the Insurance Control Law of 1965 required every company to submit annual balance sheets to the Controller of Insurance in the Ministry of Economy, there is still a serious statistical gap represented by the absence of a combined balance sheet covering insurance business in Jordan. Secondly, the recent establishment of some institutions, namely the Pension Fund and the Amman Financial Market (1976 and 1978 respectively) deprives the analysis of a more satisfactory assessment of their activities, based upon sufficient statistics describing their performance. Nevertheless,

because this thesis aims at covering the whole financial sector in Jordan, it was found necessary sometimes to resort to approximate measures to fulfil this purpose. The author's field study trip in the Summer of 1978 made the above task easier, both by conducting personal interviews with people in charge of these institutions, and by obtaining unpublished statistics which greatly helped in the following analysis.

## I

## The Contractual Financial Institutions

As distinct from deposit-type intermediaries and specialised credit institutions discussed in the previous chapters, the prime purpose of contractual financial institutions(i.e. insurance companies and pension funds) is the provision of a specialised service-protection against defined future risk as specified in insurance contracts or pension schemes. To protect themselves or their families from long-term contingencies, such as retirement and early death or lengthy survival, people usually depend on pension plans, or resort to life insurance organisations. In performing their functions, such institutions receive a continuous inflow of personal savings in the form of periodic pension and life insurance premiums. Contractual savings so mobilised are accordingly channelled, by these institutions, to different investment outlets. Such institutions are therefore significant for economic development as both mobilisers and allocators of funds.

Given the long-term nature of their liabilities, these intermediaries are in a favourable position to place their funds in long-term financial instruments. The significance of contractual financial institutions is particularly evident in developed countries where they represent effective channels for the mobilisation of national resources and their productive investment. In developing countries, in general, the insurance

industry and pension schemes are still insignificant, both in mobilising national savings and in changing the investment pattern towards long-term financing. As will be shown, such institutions are still of limited importance for Jordan's economic development as compared with their counterparts in the more advanced countries.

## I.1. The Insurance Sector

During the colonial period, insurance business in Jordan was entirely carried on by branches and agencies of foreign companies.(1) This situation continued to prevail up to 1951, when the first domestic company (Jordan Insurance Co. Ltd.) was established. However, the domestic element in the insurance industry remained very weak until the introduction of the Control of Insurance Law of 1965, which set up formal regulations governing insurance activities; the object also being to encourage Jordanian companies to enter this field. Although the absolute number of Jordanian companies remained constant (3) up to 1973, their relative importance in the total number of companies operating in the country increased after the promulgation of the Law, due to a large withdrawal of foreign companies from the market. With the Insurance Law being effective by March 1965, 15 out of the 27 operating foreign companies immediately withdrew because they were unable to satisfy the new conditions. This accordingly led, as can be seen by Table 9.1, to a noticeable rise in the relative importance of domestic companies from about only one tenth of the total to one quarter before and after March 1965. However, the recent rise in

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(1) The following historical development of insurance industry in Jordan benefited largely from information taken during three personal interviews made by the author in August 1978 with people in charge of three leading institutions:- (1) Mr. Ahmad Abdulkhaliq, General Manager, Jordan Insurance Company (2) Mr. Sami Habibi, General Manager, Middle East Insurance Company (3) Mr. Marwan Shukum, Senior Official, American Life Insurance Company.

Table 9.1 Development in the Number of Insurance Companies* operating In Jordan in Selected Years**

| | 1965 | | 1971 | 1974 | 1977 |
|---|---|---|---|---|---|
| | Before the issuance of the March 1965 Insurance Law | After the Issuance of the Law | | | |
| 1. Domestic Companies | 3 | 3 | 3 | 6 | 14 |
| 1.1. Life*** | n.a. | n.a. | (2) | (2) | ( 4) |
| 1.2. Non-Life | n.a. | n.a. | (1) | (4) | (10) |
| 2. Foreign Companies | 24 | 9 | 12 | 13 | 16 |
| 2.1. Life*** | n.a. | n.a. | (6) | (6) | (7) |
| 2.2. Non Life | n.a. | n.a. | (6) | (7) | (9) |
| 3. Total Companies | 27 | 12 | 15 | 19 | 30 |
| 3.1. Life*** | n.a. | n.a. | (8) | (8) | (11) |
| 3.2. Non-Life | n.a. | n.a. | (7) | (11) | (19) |
| (1) as % of (3) | 11.1 | 25.0 | 20.0 | 31.5 | 46.7 |
| (2) as % of (3) | 88.9 | 75.0 | 80.0 | 68.5 | 53.3 |
| (3.1) as % of (3) | n.a. | n.a. | 53.3 | 42.2 | 36.7 |
| (3.2) as % of (3) | n.a. | n.a. | 46.7 | 57.8 | 63.3 |

Source: (1) Figures for 1965 were obtained throughout a personal interview with the General Manager of Jordan Insurance Co. Ltd. in August 1978.

(2) Figures for other years, Ministry of Industry and Trade, Insurance Division, Annual Reports of Insurance in Jordan (In Arabic)

* Including branches and agencies of foreign insurance companies.

** Years for which statistics were available.

*** Including companies and agencies transacting other types of insurance besides life insurance.

insurance activities in Jordan (which largely resulted from implementing the development projects of 1973 and 1976 plans) has encouraged new Jordanian businessmen to enter this field. The number of national companies rose noticeably to 14 by 1977 as compared with 6 in 1974, thus increasing their relative share from 31.5% to 46.7%. The encouraging economic conditions have also attracted, though to a lesser degree, some foreign companies to conduct business in Jordan. The same table reveals that the number of overseas companies rose from 13 in 1974 to 16 by 1977. However, such an active entry of new companies was in excess of the absorptive capacity of the market, a situation which resulted in fierce competition in the industry, with some companies sustaining loss.(1) This accordingly led the government to temporarily cease issuing new licences for insurance business.

Until the promulgation of the Control of Insurance Law of 1965, all insurance companies were free to invest their resources abroad. This situation was similar to the freedom given to commercial banks toward overseas investment before the introduction of the Central Banking System. The above Law aimed at regulating and supervising insurance business in Jordan. A controller of insurance in the Ministry of Economy was appointed to implement the purposes of this Law. According to the Law, all insurance companies carrying on business in the country must be public shareholding companies, with the paid-up capital of a Jordanian company not less than JD 100,000, and that of a foreign company not less than the equivalent of JD 250,000.(2) Further strict conditions have

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(1) See: Jordan Insurance Company Ltd., Report of the Board of Directors, (Amman: 10 July 1978) P.9; Middle East Insurance Company, Report of the Board of Directors (Amman: 26 April 1977) P.3.

(2) Official Gazette, Control of Insurance Law of 1965, No. 1826, Articles 5 & 6 (Amman: 1.3.65)

to be met by all companies which were required to furnish (before commencing operations) as a deposit a sum of money, or its equivalent in other acceptable assets, amounting to JD 20,000 in case of life insurance, and JD 10,000 in case of general insurance.(1) The deposit has to be kept at a commercial bank in the name, and for the benefit, of the company but to the order of the Minister of National Economy. The Law also aims at influencing the pattern of resource allocation in favour of domestic investment. All foreign companies dealing in life insurance were not allowed to transfer abroad more than 10% of insurance premiums collected to meet various expenses.(2) Companies (domestic and foreign) transacting other types of insurance were also subject to restrictions as follows:(3) (1) In case of marine insurance, not less than 30% of the total premiums collected during the previous year must be retained in the country, and (2) In other classes of insurance, the above percentage was fixed at 40%.

Thus, the introduction of the above Law has regulated insurance business in Jordan within a legislative framework aiming at encouraging and influencing this vital industry in favour of national needs. It was, therefore, not surprising that the 7 Year Plan of 1964 recommended the application of the Control of Insurance Law (which was already prepared) as soon as possible.(4) The promulgation of this Law came one year after launching the Plan. However, although the Law directed insurance companies' funds towards investment in domestic activities, it nevertheless left it open for these companies to choose the type of domestic

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(1) Ibid, Article 8

(2) Ibid, Article 19

(3) Ibid, Article 49

(4) Jordan Development Board, 7 Year Programme for Economic Development, op.cit. P.345

investment without any restrictions. This appeared to result in an unsatisfactory composition of their investment portfolio, considered from an economic development viewpoint. The Three Year Plan of 1973 referred implicitly to this point by requiring further controlling of the uses of funds available to insurance companies, through more effective application of the Insurance Law.(1) As a response to this recommendation, the Minister of National Economy issued a decision, in October 1973, requiring all insurance companies to allocate a certain percentage of their reserves to the following areas, which were closely connected to development programmes-(2)

(1) 15% of total reserves for financing the industrial sector, either by subscribing to, or buying shares of industrial companies.

(2) 20% of total reserves for financing projects envisaged in the 3 Year Development Plan, which might take the form of loans extention or contribution to government development bonds and any bonds issued by concerned quarters.

(3) 5% of total reserves for financing housing loans for the employees of insurance companies, and the holders of life insurance policies.

(4) 50% of total reserves should be deposited with the Housing Bank.

Table 9.2 provides information pertaining to premiums collected by the insurance sector, classified according to type of business and nationality of company. The increasing role played by domestic insurance companies was reflected in the steady rise in their relative share in total premium collected by all companies. Between 1971 and 1976 (for which data were obtainable) domestic companies succeeded in approximately doubling their relative share from a figure of only 32.6% to 61.4%.

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(1) National Planning Council, 3 Year Plan, op.cit. P.46.

(2) Central Bank of Jordan, Tenth Annual Report, 1973, P.75 & 76.

As demonstrated by the table, the bulk of premiums collected by domestic companies came from non-life premiums which claimed, on average, 41.8% of total premiums collected by the whole insurance industry during 1971 - 1976, whereas an average of only 2.8% represented life premiums. Although foreign companies also depended more on non-life premiums (averaging 37.5% of the total), they were still more successful, than the domestic companies, in attracting life premiums which accounted for an average of 17.9% during the same period.

However, the small relative share of life premiums collected by the insurance sector as a whole (representing an average of 20.7% of total premiums) reflected the weak position of life insurance in Jordan. Despite the fact that life premiums collected were almost trebled in absolute terms, rising from only JD 0.59 million in 1971 to JD 1.50 million by 1976, still this represented a very small proportion of personal savings as compared with the situation in the more advanced countries. Whereas in the U.K., for example, savings administered by life insurance companies accounted for about 40% of total personal savings,(1) this percentage was not more than 2% in the Jordanian Case.(2) Given the relatively limited scope of public social security schemes in developing countries (including Jordan) as compared with developed countries, one would expect people there to resort more to private insurance organisations to secure their future, or that of their families. However, the weakness of life insurance business in Jordan can be explained by a combination of the following economic, religious, social, as well as educational factors:-

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(1) G. Clayton, British Insurance (London: Elek Books, 1971) P. 318

(2) Personal Savings in 1974 (the recent year for which statistics were available) accounted for JD 74.58 million.

Table 9.2 Premiums Collected Classified According to Type of Insurance and Nationality of Company, 1971 - 1976

(%)

| | | 1971 | 1972 | 1973 | 1974 | 1975 | 1976 | Average 1971-76 |
|---|---|---|---|---|---|---|---|---|
| A | Marine | 26.3 | 28.6 | 35.9 | 33.4 | 29.1 | 37.6 | 31.8 |
| B | Fire | 9.3 | 9.2 | 7.9 | 7.6 | 8.0 | 6.4 | 8.0 |
| C | Motor Vehicle | 19.6 | 22.4 | 22.3 | 28.1 | 36.8 | 35.1 | 27.5 |
| D | Accident | 13.2 | 11.3 | 9.3 | 9.6 | 15.3 | 13.2 | 12.0 |
| 1. | Non-Life Premiums (A to D) | 68.4 | 71.5 | 75.4 | 78.7 | 89.2 | 92.3 | 79.3 |
| 1.1 | Domestic Companies' Premiums | (29.7) | (31.4) | (34.6) | (41.3) | (55.2) | (58.4) | (41.8) |
| 1.2 | Foreign Companies' Premiums | (38.7) | (40.1) | (40.8) | (37.4) | (34.0) | (33.9) | (37.5) |
| 2. | Life Premiums | 31.6 | 28.5 | 24.6 | 21.3 | 10.8 | 7.7 | 20.7 |
| 2.1 | Domestic Companies' Premiums | (2.9) | (2.9) | (2.7) | (2.4) | (2.9) | (3.0) | (2.8) |
| 2.2 | Foreign Companies' Premiums | (28.7) | (25.6) | (21.9) | (18.9) | (7.9) | (4.7) | (17.9) |
| 3. | Total Premiums (1 & 2) | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| 3.1 | Domestic Companies' Premiums | (32.6) | (34.3) | (37.3) | (43.7) | (58.1) | (61.4) | (44.6) |
| 3.2 | Foreign Companies' Premiums | (67.4) | (65.7) | (62.7) | (56.3) | (41.9) | (38.6) | (55.4) |

Source: (1) Figures for the years 1971 - 1974, Ministry of Industry and Trade, Insurance Division.

(2) Figures for 1975 - 1976, the Central Bank of Jordan, Annual Report, 1977, P.53 & P.55.

(1) Economic Factors. As is known, life insurance policies serve as a channel for holding an individual's savings, besides their purpose of protecting the insured against early death or lengthy survival. The low level of per capita income in Jordan (accounting for JD 213 in 1977) made it difficult for people, in general, to accumulate large savings (thus holding insurance policies) out of their meagre income. This was made worse during the inflationary period of 1973 - 1977, wherein high price inflation (15% per annum) further minimised the ability of individuals to purchase insurance policies, due to the rising cost of living. Many life policies at this time were cancelled because of the inability of the insured to carry on paying life premiums in light of the continuous increase in domestic prices.

(2) Religious Factors. A large part of the Moslem population are still against the life insurance principle because they believe that it is in conflict with Islam's fatalistic teaching that people should submit to God's will and accept whatever the future brings to them, including death: life is not in an individual's possession but in God's hand. Thus, to insure one's life runs counter to God's alleged will.(1) The religious rejection of life insurance can be also interpreted on the ground that this activity is a type of gambling which is forbidden in Islam. In signing a life policy, an insured person knows how much he (or his family) is going to get after his death, but he does not know how much he is going to pay.

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(1) However, an increasing part of people think that life insurance is not against religion. Their argument is based on the ground that the object of insurance is not securing one's death itself, but the risk and adverse consequences that his death may bring to his family. Thus, insuring one's life, they argue, does not mean interfering in God's will but securing the future of his family when such a consequence occurs.

(3) Social Factors. Strong family relationships, which still exist in Jordan and in other Middle Eastern Countries, work to reduce the need of people for life insurance. Clearly, in circumstances where family responsibility extends towards supporting relatives in need of assistance, the protection motive for life insurance is comparatively less. In case of the death of the family's main earner, his relatives usually find ways and means by which they share their financial responsibility towards the deceased's family.

(4) Educational Factors. The development of life insurance depends largely on the readiness of people and their understanding of the benefits and the services that this industry can render to the insured, as well as to the national economy. The extent to which this industry can succeed in business is closely connected to its ability to acquaint people with its services and provide them with adequate insurance education. Although Jordanians exhibited a growing understanding of, and response to, life insurance as was reflected in the threefold increase in collected premiums in 1977,(1) there was still a large part of the population who had little knowledge of insurance benefits. This situation requires effective educational campaigns to fully acquaint the people with the twin purposes of life insurance: as a saving channel and a protection system. The educational aspect is very important for life insurance because it is only by attracting voluntary saving by the private sector that this can develop; whereas other types of insurance may greatly flourish because of government compulsory regulations (as will be shown in the case of Jordanian marine and motor car insurance).

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(1) See Table 9.3 P. 296

However, the government can indirectly promote life insurance by providing tax concessions to policy holders. The Jordanian tax system, in fact, provides some incentives to individuals but these are not sufficient to effectively encourage them to buy life insurance policies. The Income Tax Law of 1964 allows for an amount equal to 5% of an annual premium paid by an individual to be deducted from his taxable income - provided that the amount of the set-off permissible under this Article shall not exceed JD 8.(1) Clearly, such an allowance is too small compared to the situation in the U.K., for example, where savings in the form of life insurance are considerably favoured by the tax system. Among other incentives adopted by the British Government, the most important tax concession given to individuals is that half of all premiums paid can be deducted from taxable income - on the condition that eligible premiums may not exceed one-sixth of total income.(2) According to Kay and King, the substantial tax advantages attached to life insurance premiums are strongly behind the rising popularity of life insurance as a form of holding personal saving in Britain.(3)

As far as non-life (general) insurance is concerned, Table 9.2 reveals that marine insurance occupies the leading role with a relative share in total collected premiums averaging around 31.8% during 1971 - 1976. Marine insurance, together with other types of general insurance, were largely encouraged by compulsory government regulations as provided by the Control of Insurance Law of 1965. Article 47 of this Law states that any real estate and movable or immovable property within the country, or any goods imported into the country may not be insured

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(1) Official Gazette, Income Tax Law No. 25 for 1964 (Amman: 17.10.64) No. 1800, Article 32.

(2) J. Kay and M. King, The British Tax System (Oxford: Oxford University Press, 1978) P.62.

(3) Ibid. P. 63

abroad directly or indirectly by any person.(1) Moreover, all general insurance business, particularly marine insurance, has been largely promoted by the launching of the development programmes of 1973 and 1976, and the consequent increasing demand for insurance made by various economic sectors. Given the above compulsory legislative Article, together with an average annual increase in imports of 32% during the period under review, it was not surprising that marine insurance flourished remarkably to increase its relative share in total collected premiums from 26.3% in 1971 to 37.6% by 1976.

Motor vehicle insurance came second in importance with an average relative share in total collected premiums of 27.5%. This branch of insurance was not only encouraged by the above mentioned Article, but it was further assisted by another legislation, issued in 1968, requiring all vehicles to be insured. According to the Compulsory Insurance Law No.37 of 1968,(2) all movable vehicles operating in the country should be covered at least by third party insurance. Although statistics for this period were not available to indicate the effect of this Law, clearly, this must have greatly promoted the development of motor vehicle insurance.

The distinction between life and non-life insurance is particularly important when discussing the significance of the insurance industry for a country's economic development. The developmental impact of insurance organisations lies basically on their role as financial intermediaries, which can potentially be an effective vehicle for the mobilisation of national savings and their utilisation in capital market's instruments. In this regard, life insurance companies are favourably placed to serve as long-term investors in the capital market, compared to their general

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(1) Official Gazette, Control of Insurance Law of 1965, op.cit. Article 47

(2) Reference is made here to the personal interview conducted by the author with Mr. Abdulkhaliq, General Manager of Jordan Insurance Company.

insurance counterparts. The investment behaviour of companies dealing with life insurance usually shows a preference towards long-term financial instruments which, in effect, reflects the long-term nature of their liabilities and their less need for liquidity. The contract in life insurance differs from that in general insurance because it is usually a long-term one and the premiums are collected over a period of years; whereas the contract in general insurance is normally agreed on an annual basis.(1) Given this situation, the investment pattern of the latter is largely biased towards the holding of short-term assets to satisfy high liquidity needs, whereas lesser need for liquidity in the case of the former enables the investment managers there to channel the largest part of the steady inflow of premiums into long-term investments.(2)

Since a consolidated balance sheet of insurance companies is still not available in Jordan, it is difficult to analyse and assess satisfactorily the role of the insurance industry in the country's economic development (by examining sources and uses of funds). The lack of required statistics, moreover, makes it also difficult to examine the extent to which the above theoretical distinction in portfolio behaviour between life and non-life insurance companies applies to the Jordanian case. However, taking collected premiums as a crude measure of their mobilisation of the contractual savings of the community, Jordanian insurance industry showed steady progress. Table 9.3 demonstrates that total premiums rose from only JD 1.86 million in 1971 to JD 8.84 million by 1977. Despite this progress, however, the industry still plays a

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(1) For a detailed differentiation between the two types of insurance, see Clayton, G. and Osborn, W., Insurance Company Investment; Principles and Policies (London: Allen & Unwin, 1965) PP. 11-14

(2) For the role of each type of insurance in the capital market, see G. Clayton, British Insurance, op.cit. PP. 313 - 339

limited intermediary role compared to other financial institutions, especially the commercial banks. Throughout the period under review, for example, collected premiums constituted only 0.01% of GNP, whereas bank deposits accounted for 30% of GNP during the same period.

Moreover, the extent to which insurance companies were able to make funds available in the capital market can be shown by their net acquisition of premiums after allowing for the outflow of claims. Insurance companies receive each year an inflow of premiums exceeding disbursement to policy-holders plus overhead expenditure, thus investing the surplus in different assets to cover their liabilities. The ability of the insurance industry to accumulate such surpluses is indicated by the ratio of premiums collected (P) to compensation paid (C).(1) P/C figures, therefore, reveal how many times the funds mobilised by the insurance sector (in the form of premiums) cover the payments of claims. Table 9.3 illustrates that P/C ratio for all insurance companies averaged around 2.2 during the whole period, indicating that premium inflow was more than twice the outflow of claims. The same table also demonstrates the favourable position of life insurance companies as potential investors in the capital market; this is reflected in their higher P/C ratio compared to their non-life insurance counterparts. An average P/C ratio of 6.4 for the former and only 2.0 for the latter clearly reflected the relative significance of life insurance companies in making more funds available for capital market activities, compared to the general insurance business.

Finally, it can be concluded that the insurance industry in Jordan is still of minor importance for economic development. Since it is incapable of mobilising substantial amounts of national savings, it is therefore unable to feed the market with considerable investable funds

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(1) Such surpluses would be available for investment after allowing for administration and other costs.

Table 9.3 Premium Collected (P) and Compensation Paid Out by Insurance Companies (C) Classified According to Type of Insurance, 1971 - 1977

| | Life Insurance | | | Non-Life Insurance | | | Total Insurance | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | P | C | P/C | P | C | P/C | P | C | P/C | P/GNP |
| | JD'000 | JD'000 | % | JD'000 | JD'000 | % | JD'000 | JD'000 | % | % |
| 1971 | 588 | 83 | 7.1 | 1,275 | 796 | 1.6 | 1,863 | 879 | 2.1 | 0.008 |
| 1972 | 625 | 101 | 6.2 | 1,570 | 600 | 2.6 | 2,195 | 701 | 3.1 | 0.008 |
| 1973 | 664 | 192 | 3.5 | 2,039 | 736 | 2.8 | 2,703 | 928 | 2.9 | 0.009 |
| 1974 | 756 | 117 | 6.5 | 2,792 | 1,545 | 1.8 | 3,548 | 1,662 | 2.1 | 0.009 |
| 1975 | 413 | 29 | 14.2 | 3,419 | 1,911 | 1.8 | 3,832 | 1,940 | 2.0 | 0.010 |
| 1976 | 483 | 142 | 3.4 | 5,806 | 3,153 | 1.8 | 6,289 | 3,295 | 1.9 | 0.012 |
| 1977 | 1,503 | 371 | 4.1 | 7,332 | 5,496 | 1.3 | 8,835 | 5,867 | 1.5 | 0.014 |
| Average% 1971-77 | | | 6.4 | | | 2.0 | | | 2.2 | 0.010 |

Source: As Table 9.2

necessary for financing long-term development needs. Their small significance for capital market development is shown by the fact that by the end of 1977, the financial investment in government bonds and companies' shares of three leading insurance companies[1] did not exceed 1% of the paid-in capital of the public shareholding companies listed on

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(1) These are: Jordan Insurance Company, Middle East Insurance Company, and the American Life Insurance Company. According to unpublished figures prepared by the Monetary Division at the Central Bank of Jordan, the above three mentioned companies were estimated to hold about 80% of the total assets held by the whole insurance sector. As of Dec. 1977, the assets held by each of these companies accounted for JD 4.78 million, JD 1.21 million and JD 2.60 million respectively.

the Amman Financial Market.(1) This situation was unfavourably compared with the important allocative function of insurance companies in developed countries. In the U.K., for example, the large resources of insurance companies, and their willingness to hold long-term investments, made such intermediaries able to operate as active investors as well as underwriters in the London Stock Exchange, a factor which considerably promoted and strengthened the activity of this institution. According to Clayton and Osborn, British insurance companies usually underwrite more than half of any new issue in the capital market.(2)

## I.2. The Pension Fund (PF)

Pension and provident funds are insurance-type institutions, which are also classified as social security programmes. Such specialised institutions differ widely from one country to another, depending on their scope of coverage, methods of financing, and whether they are administered by the state or by the private sector. The significance of these funds is not only related to the social service they provide, but they are also important for economic development as financial intermediaries, deriving their funds mainly from contractual savings which are subsequently invested in long-term activities.

In general, pension plans are designed to pay on retirement a pension equal to some fixed percentage of employee's final salary. Benefit payments are mainly financed by contributions from employees,

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(1) Government bonds and industrial shares held by the three companies, accounted for less than JD 1.0 million (see balance sheet figures), whereas the paid-in capital of listed shareholding companies was JD 110.10 million. (See Hashim Sabbagh," Amman Financial Market: Role & Objectives," Amman: 1978) P.5.

(2) Clayton and Osborn, Insurance Company Investment, op.cit. P.231

together with other sources, such as earnings on investments and government subsidies. Provident funds, on the other hand, mobilise compulsory savings from certain categories of employees covered in the scheme and contributions from their employers. In case of retirement, for example, contributors receive benefits consisting of their share in the accumulated savings plus interest accrued, mostly payable in one lump sum.(1) Both pension and provident funds can accumulate surplus so long as contributions on behalf of covered and currently working employees (inflow) are in excess of the compensation paid to the retirees (outflow). The surplus so accumulated can be channelled to various investment outlets, thus giving such institutions an important role in financial intermediation.

The intermediary function of pension and provident funds is of a special significance for economic development because such institutions are more able than other financial intermediaries to feed the market with continuous inflow of long-term investable funds. Unlike commercial banks and other saving institutions, the liabilities of pension funds are of a longer-term nature which facilitates their investment in long-term assets. In contrast to bank deposits, people consider their savings with pension and provident funds as completely illiquid, since they cannot withdraw them for a long period of years. The liabilities of such funds are payable only when the retirement is due, thus giving them a high degree of predictability. This, together with the complete absence of sudden withdrawals on their liabilities, enable these institutions to hold riskier and longer-term investment portfolio more than any type of financial intermediaries.

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(1) For a detailed discussion of various social security programmes, and their mobilisation role, see: Franco Reviglio," Social Security: A Means of Saving Mobilisation For Economic Development," IMF Staff Papers (July 1967) PP. 324 - 362

As far as Jordan is concerned, pension and provident schemes are still of limited importance compared to other countries where such institutions are instrumental in fostering domestic development. Provident funds are privately established in large commercial and industrial corporations, where employees can draw lump sum severance and retirement payments when they leave work. Employers also contribute to the aggregate funds which are usually administered and invested by the corporations. Due to the absence of any published statistics or information regarding such funds, it is very difficult to reveal their pattern of investment or the extent to which they make resources available for financing development. However, it is believed that the resources accumulated by private provident funds are not large enough to form an important source of development finance.

It was not until 1976 that a pension fund for government employees was introduced in Jordan. Prior to this date, pension affairs were dealt with by a special department within the Ministry of Finance. The Pension Fund (PF) was established, in accordance with the provisional Law No. 6 of 1976, to shoulder the present and future obligations of the government as stipulated in the country's civil and military pension laws.(1) In addition to this purpose, the PF also aims at playing a promotional role in the Jordanian economy, by investing its resources in projects within the framework of development programmes.(2)

The PF was created in response to a recommendation made by the Three Year Plan of 1973.(3) This came into effect in 1976, when the Central Bank of Jordan took the initiative by transferring JD 15.40

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(1) Pension Fund, Law No. 6 For 1976, Article 4.A.

(2) Pension Fund, Report on the operations of the Fund, (Amman: June 1978) In Arabic, P.1.

(3) National Planning Council, Three Year Plan, op.cit. P.43

million of its profits to form the paid-in capital of the new institution. During this year, special profits accrued to the Bank as a result of revaluation of its gold holdings at the new price of U.S. $ 100 per ounce (instead of the previous rate of $ 35 per ounce).(1) Such profits are usually transferred to support the government budget. Instead of financing current government expenditures, it was decided this time to use the profit to constitute the capital of a new institution capable of promoting and financing development projects.(2)

However, it seems that the Law creating the PF, and the studies prepared earlier, did not give sufficient consideration to the methods of funding and their adequacy to meet the PF obligations, in view of the prevailing civil and military pension laws. Thus, as the PF started operations, it soon realised the difficulty of operating on a self-funded basis, since its current revenues were much less than needed to cover current obligations towards pensioners. A report prepared by the PF estimated a deficit of JD 9.78 million during 1978.(3) Benefit outflows were estimated at JD 12.98 million, whereas employees' contributions together with current revenues from investment were expected to reach only JD 3.20 million. Given this situation, the PF envisaged three ways to solve this problem.(4)

(1) Changing the existing government pension laws with the purpose of increasing the current inflow of funds. This would mainly involve lengthening the work period of employees and the percentage deducted from their salaries.(5) Moreover, the government would also be required

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(1) Pension Fund, Report on the Fund operations, op.cit, P.1.

(2) Ibid.

(3) Ibid. P.10

(4) Ibid. P. 10 - 13

(5) Uruguay, for example, has a successful social security sector because of high contributions made by employees, ranging from 38.5% to 44.5% of wages and salaries. See Reviglio, op.cit, P. 330

to support the current inflow by transferring to the PF a certain percentage of employees' contributions (a case similar to private provident funds where employers pay, for example, double the percentage paid by the employees).

(2) Providing lump sum payments by the government whenever the PF faces financial difficulty. It was estimated that the PF required JD 120 million in order to meet its obligations during the coming three years. Government subsidies would be needed from time to time to enable the PF to assume its financial obligations as shown by the Law.(1)

(3) Finally, it was proposed to change the PF to a state investment corporation, specialising only in investing funds and promoting development projects, without a direct commitment to pension obligations. According to this solution, the Ministry of Finance would continue, as before, to meet its obligations towards pensioners. Any profits that accrued to the proposed corporation would be transferred to the government to help in financing part of pension expenditures.

However, the PF's Board of Directors was in favour of the last solution, emphasising the necessity of amending the Fund's Law with the purpose of changing the PF to a state investment corporation.(2) This decision was taken in view of the country's utmost need for a specialised investment institution with sufficient resources capable of promoting and financing development projects. Thus, a proposed Law was prepared in

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(1) This was the experience in many developing countries, such as Columbia, Argentina, and Brazil, where large government subsidies made their social security programmes successful. Even in the more developed country, such as France, Belgium, and Italy, pension funds were greatly assisted by considerable transfers from their respective government. See Reviglio, op.cit. Table 4 (P.337) and Table 6 (P.340)

(2) Pension Fund , Report on the Fund operations, op.cit. P.11

1978 to be officially approved, giving a new name for the PF as "Jordan Investment Corporation" with an authorised capital of JD 25 million. According to the proposed Law, the new corporation is expected to play an active developmental role by creating viable development projects within the country through (a) undertaking comprehensive investment surveys and initiating feasibility studies of selected enterprises, (b) financing these projects directly, or arranging for their finance from domestic and foreign sources. Development finance can be also met through undertaking joint-venture projects, with the corporation shouldering a higher risk than other partners. The Corporation also aims at supporting the operations of the recently established Amman Financial Market through active dealings in the listed financial instruments, and by encouraging the establishment of specialised saving and investment organisations.

Thus, the proposed amending Law aims at creating a new institution specialising in the investment field, without committing itself to pension obligations as was the case in the previous PF's Law. Article 5 of the proposed Law confines the aim of the new Corporation to investing its resources in Jordanian projects with close relation to development plans. The only connection between the Corporation and pension obligations is shown in Article 16 of the proposed Law, which states that all net profits accruing to the Corporation should be transferred to the government as contributions to pension payments. Employees' contributions to pensions should be channelled to the Corporation for investment (together with its capital and any funds transferred by the government and the Central Bank) in areas closely connected with development programmes. Given this situation, the proposed institution is not a pension fund in the real sense, rather it is an investment agent of the government specialising in financing and promoting development projects.

The PF's Board of Directors has already taken steps to move towards the above proposed Corporation. It asked the Ministry of Finance to continue dealing with pension affairs, thereby enabling the PF to concentrate its activities in the investment field.(1) As regards its role in the capital market, the proposed new corporation would have a promotional impact, similar to that of the PF, as a long-term investor in the market. The nature of liabilities in both institutions is the same, in the sense of their predictability and the absence of a sudden withdrawal by the public. The new institution may be even more capable of feeding the market with long-term investable funds, given its larger resources and a higher degree of specialisation in investment.

However, the extent to which the PF was significant in capital market activity was shown in Table 9.4. Since its existence in 1976

Table 9.4 The Allocation Pattern of Pension Fund's Resources, 1976 - 31/5/1978

(Millions of JD)

| | 1976 | | 1977 | | 31/5/78 | | Average % |
|---|---|---|---|---|---|---|---|
| | Value | % | Value | % | Value | % | 76 - 78 |
| 1. Government Bonds | 8.77 | 56.8 | 6.19 | 39.7 | 7.68 | 40.9 | 45.8 |
| 2. Companies' Shares | 6.44 | 41.7 | 8.52 | 54.7 | 10.07 | 53.5 | 49.9 |
| Capital Market Assets (1 & 2) | 15.21 | 98.5 | 14.71 | 94.4 | 17.75 | 94.4 | 95.7 |
| 3. Deposits with Banks | 0.06 | 0.4 | 0.66 | 4.2 | 0.83 | 4.4 | 3.0 |
| 4. Others | 0.17 | 1.1 | 0.22 | 1.4 | 0.22 | 1.2 | 1.3 |
| Total Assets | 15.44 | 100.0 | 15.59 | 100.0 | 18.80 | 100.0 | 100.0 |

Source: Pension Fund, Report on the Fund operations, (Amman: June 1978) Arabic.

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(1) Pension Fund, Report on the Fund operations, op.cit. P. 1 & 2

up to May 1978, Capital Market instruments held by the PF comprised, on average, 95.7% of its total resources. The remaining small percentage of only 4.3% was held in other forms, mainly in bank deposits, thus reflecting its little need of liquidity. The PF's investment behaviour is consistent with the earlier theoretical discussion which favourably places pension funds as important holders of capital market instruments. In fact, such an allocation pattern of resources distinguishes the PF as an active investor in the capital market, compared to other financial intermediaries. As was shown in preceding chapters, commercial banks were very reluctant to invest in long-term financial assets; specialised credit institutions concentrated their activities in credit extension, with a very small proportion of their funds being invested in equities; even insurance companies (which are usually active investors in the capital market) were found to be of small significance, due mainly to their limited financial resources. The important role played by the PF in the capital market is shown by the relative share of its long-term holdings of financial assets in total assets available in the market, a percentage accounting for about one tenth by 1977.(1) This represented 14.4% of government bonds outstanding and 7.7% of the paid-in capital of the public shareholding companies registered at the Jordanian Exchange. However, although such a contribution is considerable comparing with that made by other domestic financial intermediaries, the role of the PF in the capital market is still limited compared to the situation in other developing countries, where pension funds play an important role in financing development. In developing countries where pension schemes reached advanced levels, such as Malysia, Uruguay, Panama, and Argentina,

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(1) Government debt outstanding accounted for JD 43 million, whereas the paid-in capital of the listed companies formed JD 110.10 million. As a percentage of the total government and private capital market assets, a holding of JD 14.71 million by the PF represents 9.6% of the total.

pension funds there were able to mobilise large funds which were then made available for financing capital market activities. For example, pension funds' holdings of government bonds, as percentages of public debt outstanding in the four mentioned countries, accounted for 60%, 53%, 40%, and 39% respectively.(1)

## II

## The Post Office Saving Fund (POSF)

Post office savings facilities form part of an existing governmental system aiming at mobilising funds from small savers and channelling them into investment outlets. Their location in post offices make them accessible to a large part of the population who are already by use familiar with and confident in the post office. Such facilities are especially important in developing countries where they can, through an adequate geographical coverage, develop habitual savings trends among people belonging to low-income groups, whose savings are too small to attract the attention of other types of financial intermediaries.

The post office savings system in Jordan is of a recent inception, having been introduced only in 1974. In September of that year, the Post Office Saving Fund(POSF) started operations in accordance with Law No. 34 of 1966, and the Law amending it, No. 11 of 1974. The principal purpose of the POSF is to develop the saving habit among Jordanians and to increase their knowledge of the concept and benefit of savings, particularly with regard to small savers.(2) To encourage individuals to use the savings facilities provided by the post offices, Article 5 of the Law states that the government guarantees all the Fund's liabilities

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(1) See Reviglio, op.cit. Table 12, P.352

(2) Post Office Saving Fund, Law No. 11 of 1974, Article 4

towards the others. In addition to creating public confidence, the Law also provides two forms of financial incentives aiming at encouraging the POSF: (a) excluding all the fund's activities from government fees and, (b) exempting interest earned on deposits held with the Fund from income tax.(1) The extent to which this has been effective in mobilising savings will be now examined.

Table 9.5 demonstrates that the POSF has been active in extending the network of its offices throughout the country. The number of offices rose steadily from only 24 in 1974 to 87 by July 1978, with the largest increase being experienced in areas outside Amman. The relative share of Amman's offices declined gradually during the whole period, reaching 21% of total branches by July 1978, as compared with 42% when the POSF commenced operations in 1974. In absolute terms, the number of offices operating in areas other than Amman increased more than five times (rising from only 14 to 69), whereas Amman's offices were less than doubled (increasing from 10 to 18) during the period. Such an expansion was instrumental in attracting new depositors as reflected in the steady rise in their number, which reached 42,223 by July 1978 as compared with only 7,308 in 1974.

Given the minimum deposit acceptable by the POSF of half a Jordanian Dinar, the above noticeable increase in the number of depositors did not necessarily lead to an equally important rise in deposits. The same table shows that although deposits mobilised from the public increased more than 18 times during the period under study, these deposits were still very small, not exceeding JD 1.50 million by July 1978. This figure represented only less than 0.5% of private sector's deposits mobilised by the commercial banks.(2) The fact that post office savings facilities

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(1) Ibid, Article 10

(2) Interest paid by the POSF was competitive with that paid by commercial banks. In an attempt to attract further resources, the POSF raised the interest rate three times since its existence. It was, firstly, increased from 4% to 5% in 1975, then to 5½% in 1976 and, finally, to 6% in 1977.

Table 9.5

## Geographical Distribution of Post Office Saving Offices and Development in Deposits and number of Depositors, 1974 - 31.7.1979

| Year | Amman Area | | | | | | Other Areas | | | | | | Total | | | | | | Average Deposit held by each depositor (4)=(3÷2) (JD) | % of depositors to total population (5) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | No. of offices | | No. of depositors | | Deposits | | No. of offices | | No. of depositors | | Deposits | | No. of offices | | No. of depositors | | Deposits | | | |
| | Absolute | % to (1) | Abs. | % to (2) | Abs. (JD'000) | % to (3) | Abs. | % to (1) | Abs. | % to (2) | Abs. (JD'000) | % to (3) | Abs. (1) | % | Abs. (2) | % | Abs. (JD'000) (3) | % | | |
| 1974 | 10 | 42.0 | n.a. | n.a. | 0,049 | 62.8 | 14 | 58.0 | n.a. | n.a. | 0,029 | 37.2 | 24 | 100.0 | 7,308 | 100.0 | 0,078 | 100.0 | 11 | 0.3 |
| 1975 | 10 | 27.0 | n.a. | n.a. | 0,231 | 66.8 | 27 | 73.0 | n.a. | n.a. | 0,115 | 33.2 | 37 | 100.0 | 16,879 | 100.0 | 0,345 | 100.0 | 21 | 0.6 |
| 1976 | 14 | 26.9 | 19,427 | 60.0 | 0,519 | 63.2 | 38 | 73.1 | 12,925 | 40.0 | 0,302 | 36.8 | 52 | 100.0 | 32,352 | 100.0 | 0,821 | 100.0 | 25 | 1.2 |
| 1977 | 16 | 22.2 | 20,575 | 54.6 | 0,762 | 61.3 | 56 | 77.8 | 17,114 | 45.4 | 0,482 | 38.7 | 72 | 100.0 | 37,689 | 100.0 | 1,244 | 100.0 | 33 | 1.3 |
| July 1978 | 18 | 20.7 | 23,619 | 54.6 | 0,913 | 60.9 | 69 | 79.3 | 19,604 | 45.4 | 0,586 | 39.1 | 87 | 100.0 | 43,223 | 100.0 | 1,499* | 100.0 | 35 | 1.5 |
| Average '74 - July 78 | | 27.7 | | 56.4 | | 63.0 | | 72.3 | | 43.6 | | 37.0 | | 100.0 | | 100.0 | | 100.0 | 25 | 1.0 |

Source: Post Office Savings Fund, Unpublished Statistics.

* Deposits outstanding at June 30, 1978

were mainly introduced to encourage the savings of low-income groups led to the holding of a large number of small accounts, which is reflected in the small average of deposit held by each customer (i.e. JD 25).

The limited size of savings attracted by the POSF clearly demonstrates its weak position amongst other financial intermediaries as a channel for mobilising funds. However, the significance of this institution should not only be judged on quantitative terms, but also the qualitative aspect of its activity should be taken into consideration. The geographical expansion of branches and their accessibility to the public must have encouraged the saving habit among small savers. The extention of activities to villages and remote areas of the country must have attracted a large number of customers, with small savings, who were not used to dealing with financial intermediaries. According to statistics obtained directly from the POSF, about 60% of the post office savings facilities in 1978 were located in small villages where other ordinary financial institutions hardly existed. The success of the POSF in attracting new customers was shown by the rise, albeit slowly, in the percentage of depositors to total population throughout the whole peiod. Table 9.5 shows that whereas only 0.3% of the total population had access to the saving facilities provided by post offices in 1974, this percentage rose to 1.5% by July 1978. Despite this, however, the population covered by the POSF was still small compared to other developing countries with effective postal savings systems . In Malaysia,for example, the number of depositors who had access to post office savings facilities comprised 15% of total population.(1)

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(1) R. Emery, The FinancialInstitutions of South East Asia - A Country-by-Country-Study (London: Praeger Special Studies, 1970) P.333.

Since the funds deposited with the POSF were small in size, this institution was consequently unable to provide considerable amounts of development finance. Table 9.6 demonstrates this fact, showing that capital market assets held by the POSF accounted for JD 1.42 million by July 1978, a figure less than 1% of the total assets available in the Jordanian Exchange.(1) However, the pattern of the POSF resource allocation indicated a clear preference towards holding capital market assets, which absorbed 85.3% of its total resources in July 1978 (cash and deposit held with other banks formed only 4.9%). This pattern of investment reflected the relatively stable nature of the POSF's liabilities represented in saving deposits (which claimed 90.3% of total resources), the remaining percentage being advances from the government. Given the favourable position of capital market assets in the investment portfolio of the POSF, it can be said that this institution is expected to play an important role in capital market activities once sufficient resources are mobilised from the Public.

Chapter 10 now concludes this survey of the non-bank financial sector with an analysis of the Amman Financial Market.

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(1) See footnote (1) P.297

Table 9.6

## Sources and Uses of Funds of the POSF, 1974 - 30.6.1978

(JD 1000)

| Year | Sources of Funds | | | | Total Resources (1) | | Uses of Funds | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Savings Deposits | | Govt. Advances* | | | | Cash & Deposit with Banks | | Capital Market Assets | | | | | | Others | |
| | | | | | | | | | Govt. Bonds | | Companies' Shares | | Total | | | |
| | Absolute | % to (1) | Absolute | % to (1) | Absolute | % | Absolute | % to (1) | Absolute | % to (1) | Absolute | % to (1) | Absolute | % to (1) | Absolute | % to (1) |
| 1974 | 0,078 | 100.0 | - | - | 0,078 | 100.0 | 0,078 | 100.0 | - | - | - | - | - | - | - | - |
| 1975 | 0,358 | 97.3 | 0,010 | 2.7 | 0,368 | 100.0 | 0,068 | 18.5 | 0,272 | 73.9 | 0,018 | 4.9 | 0,290 | 78.8 | 0,010 | 2.7 |
| 1976 | 0,821 | 96.7 | 0,028 | 3.3 | 0,849 | 100.0 | 0,053 | 6.2 | 0,678 | 79.9 | 0,090 | 10.6 | 0,768 | 90.5 | 0,028 | 3.3 |
| 1977 | 1,244 | 96.1 | 0,050 | 3.9 | 1,294 | 100.0 | 0,114 | 8.8 | 0,806 | 62.3 | 0,342 | 26.4 | 1,148 | 88.7 | 0,032 | 2.5 |
| 30/6/78 | 1,499 | 90.3 | 0,161 | 9.7 | 1,660 | 100.0 | 0,082 | 4.9 | 1.066 | 64.2 | 0,350 | 21.1 | 1,416 | 85.3 | 0,162 | 9.8 |
| Average Percentage 1974-30/6/78 | | 96.1 | | 3.9 | | 100.0 | | 27.7 | | 56.1 | | 12.6 | | 68.7 | | 3.6 |

Source: Post Office Saving Fund

* Including small other items.

# CHAPTER 10

## THE AMMAN FINANCIAL MARKET

The significance of a stock exchange for a country's economic development lies on its potential role as a catalyst by which the long-term savings of the community can be converted into productive real investment.(1) Given this important function, many developing countries have emphasised the development of a domestic securities market as an instrument for promoting growth, without sometimes proper examination of the expected benefits and opportunity costs that this process may involve, particularly as the benefits accompanying the introduction of such institutions in developing countries can be greatly limited by the prevalence of an underdeveloped economic and financial environment.(2) This chapter attempts to examine and assess the recent introduction of a domestic stock exchange in Jordan.

As is the general case in developing countries, Jordan's Stock Exchange followed a supply-leading pattern of evolution, and was further encouraged by government legislation and promotional policies. The necessity of introducing such a specialised institution was repeatedly emphasised by development planners, as shown by the country's three

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(1) David Williams, "The Growth of Capital and Securities Markets", Finance and Development (September 1966) P.214

(2) Wai and Patrick "Stock and Bond Issues and Capital Markets in Less Developed Countries", IMF Staff Papers (July 1973) P.254

development plans of 1964, 1973, and 1976. Although the creation of a domestic securities market was recommended in the 7 Year Plan as early as 1964, the actual establishment of this institution took place only in 1976, when a special law creating the Amman Financial Market (AFM) was passed. This delay raises a number of issues to which answers must be sought -

(1) WHY WAS THE CREATION OF A DOMESTIC CAPITAL MARKET SO PROLONGED?

In recommending the creation of a domestic capital market, the 7 Year Plan of 1964 noted:

> ..."considering the state of recent economic and financial development in Jordan, serious efforts must be made to encourage and accelerate the growth of a capital market in the country. Although the development of such an institution is essentially a slow process, its early establishment would be instrumental in orienting Jordan's financial structure to the long-term growth requirements and potentialities of the economy."(1)

The Plan stated that such a market should be established before January 1966. However, whether the above recommendation was a rational one needs to be examined with particular reference to the stage of economic and financial development attained by the country at that time.

Important studies have been undertaken by many economists to examine the constraints and the conditions necessary for the introduction of a capital market in the particular environment of a developing economy.(2) One such study by Arolow outlines some of the necessary pre-conditions for a reasonably workable capital market to emerge in a developing economy.(3) These are related to both sides of the market: the supply of capital market instruments by various deficit units, and the demand

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(1) Jordan Development Board, The 7 Year Programme For Economic Development, op.cit. P.345.

(2) See: Edward Arolow, "The Development of Capital Markets in Africa, with Particular Reference to Kenya and Nigeria", IMF Staff Papers, (July 1971) PP.420-469; George Maniatis, "Reliability of the Equities Market to Finance Industrial Development in Greece", Economic Development and Cultural Change (Vol. 19 for 1970-71), PP 598-620; and Wai & Patrick, op.cit. PP.253 - 302.

(3) Arolow, op.cit. P.423.

for them made by different surplus units. On the supply side, there should be a large supply of securities and new issues available on a regular basis. On the demand side, there has to be (a) a fair degree of monetization of an economy to permit a sufficient inflow of savings in financial forms. (b) There is a need for a certain degree of sophistication of behaviour among investors, which directs their investments towards holding long-term financial instruments vis-a-vis physical assets and short-term monetary assets. In addition to supply and demand factors, Arolow added a further condition that a network of financial institutions must be either in existence or developed in order to facilitate and promote capital market activities.

To what extent were these forces of supply and demand sufficient in Jordan to introduce a domestic capital market immediately following the recommendation of the 7 Year Plan? During 1964 - 1972, there was an obvious lack of adequate statistics and information, which made the task of examining any actual or latent forces of supply and demand extremely difficult. For example, to reveal the size of potential supplies of capital market assets, statistics pertaining to the number of companies, type of ownership (whether private or public shareholding companies), and financial statements revealing their capital structure and methods of financing were conspicuously lacking. Therefore, it is necessary to resort to general, though less accurate, indicators to fulfil the purpose.

On the supply side, the structure of the Jordanian economy with its very narrow industrial base appeared to minimise the opportunity for offering volumes of securities sufficient to operate a reasonably workable capital market. Clearly, a relatively extensive industrial foundation usually offers a wide scope for the supply of capital market assets to finance expansion; whereas on the other hand, the predominance of agriculture (with relatively small-scale producers and a high self-finance element) minimises the scope for potential supply of corporate securities.(1)

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(1) See Arolow, op.cit. P.427, and Maniatis, op.cit. P.600.

Jordan's manufacturing sector was still at an early stage of development, contributing only 9.2% to GDP in 1964, whereas agriculture's relative share accounted for about 25%. The weak industrial base of the country continued to prevail throughout the period under review, with an average relative contribution from industry of only 10.7%. Not only was the opportunity for issuing corporate shares circumscribed by the country's narrow industrial structure, but the type of ownership of industrial concerns also worked to minimise the potential supply of such assets. A characteristic feature of Jordanian companies was that they were either family-owned or private shareholding enterprises, both of which did not offer their shares for public subscription. Although statistics to support this fact are not available, figures issued at the close of the period (1972) showed the relatively small number of public shareholding companies, which were able to offer stocks to the investing public. Only 72 out of the existed 2,671 Jordanian companies were publicly owned with share capital of a mere JD 44.53 million.(1)

The scope for the supply of capital market assets was also narrowed by serious political instability during this period, which adversely influenced the rate of economic growth and, subsequently, the potentialities for raising capital to finance expansion. All development projects included in the 7 Year Programme were suspended following the 1967 War and the subsequent Israeli occupation of the West Bank. Continuous political unrest in the country, which culminated in the civil war of 1970, further added to the serious deterioration in economic activity. This was reflected in a slow or negative rate of growth in GDP during

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(1) Ministry of Economy, Companies Control Division, Second and Third Annual Report of Jordanian Companies, 1972 - 1973, (Amman: Co-operative Press Workers Society) P.56 (Arabic).

this period as shown by Table 10.1. Thus, given the aforementioned structural characteristics of the Jordanian economy, together with a slow rate of economic growth and a high degree of political instability, it can be safely said that the potential supply of securities was not enough to create a viable operative stock exchange in the country.

As indicators of the demand for capital market assets, four approaches can be used as shown in Table 10.1.-

(1) Private Sector's Savings/GNP ratio indicates the ability of individuals to accumulate savings out of their income (which can be possibly used for purchasing securities).

(2) The Monetization ratio reflects the degree to which the economy is monetized (which is important to permit and facilitate the accumulation of savings in financial forms).

(3) Quasi money/M2 ratio gives an indication of the degree of sophistication of investors and their willingness to hold long-term financial assets vis-à-vis short-term assets.

(4) Finally, the relative importance of individuals' holdings of government bonds in total bonds outstanding reflects people's preference to invest in more advanced forms of wealth (represented in capital market assets).

The same table also reveals the weak potential demand for securities as reflected in the small proportion of total incomes allocated to savings. Throughout the period 1964 - 1972, the ratio of private sector savings to GNP was low, averaging around 13.4%. This situation was similar to the general experience of less developed countries where people managed to save an annual average of 13% of total income during 1960 - 1966, a much lower ratio than the 21% experienced in the more advanced countries.(1)

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(1) A. Kamarck, "African Economic Development: Problems and Prospects", African Report (Washington: Jan, 1969) Vol. 14, PP.16-18. (cited by Arolow, op.cit. P.425).

Table 10.1 Indicators Revealing the Potential Supply of Capital Market Assets and the Demand for them in Jordan, 1964 - 1977

%

| Years | Supply Indicators | | | Demand Indicators | | | |
|---|---|---|---|---|---|---|---|
| | Annual Growth In GDP | Relative Share of Agriculture In GDP | Relative Share of Manufacturing* In GDP | Ratio of Private Sector's Savings to GNP | Monetization Ratio (M2÷GNP) | Ratio of Quasi-Money to M2 | Relative Importance of Individuals' Holdings of Govt.Bonds** |
| 1964 | 15.4 | 25.2 | 9.2 | 12.1 | 33.4 | 25.7 | n.a. |
| 1965 | 11.0 | 22.6 | 10.7 | 10.8 | 35.6 | 26.4 | n.a. |
| 1966 | -1.4 | 18.5 | 11.5 | 4.2 | 40.8 | 26.1 | n.a. |
| 1967 | 18.8 | 21.9 | 9.9 | 12.7 | 45.7 | 20.1 | n.a. |
| 1968 | -5.0 | 16.3 | 11.9 | 16.9 | 55.1 | 19.1 | n.a. |
| 1969 | 17.8 | 18.3 | 11.6 | 20.0 | 50.8 | 19.0 | n.a. |
| 1970 | -4.5 | 15.1 | 10.4 | 16.4 | 58.0 | 18.3 | n.a. |
| 1971 | 6.9 | 18.7 | 10.1 | 11.5 | 57.1 | 20.0 | 7.5 |
| 1972 | 7.4 | 18.9 | 11.3 | 16.4 | 55.7 | 21.5 | 4.0 |
| Average 1964-72 | 7.4 | 20.0 | 10.7 | 13.4 | 48.0 | 21.8 | 5.7 |
| 1973 | 3.2 | 13.3 | 11.9 | 13.2 | 60.3 | 20.9 | 12.9 |
| 1974 | 28.0 | 17.7 | 15.9 | 20.0 | 57.9 | 21.5 | 18.4 |
| 1975 | 11.1 | 9.7 | 18.1 | n.a. | 70.3 | 21.3 | n.a. |
| Average 1973-75 | 14.1 | 13.6 | 15.3 | 16.6 | 62.8 | 21.2 | 15.6 |
| 1976 | 24.5 | 11.1 | 18.2 | n.a. | 68.5 | 26.6 | 19.3 |
| 1977 | 17.9 | 10.5 | 17.7 | n.a. | 71.5 | 28.3 | 23.2 |
| Average 1976-77 | 21.2 | 10.8 | 17.9 | n.a. | 70.0 | 27.5 | 21.3 |
| Average 1973-77 | 16.9 | 12.5 | 16.4 | n.a. | 65.7 | 23.7 | 18.5 |

Source: Appendix 4.4; Table 3.6; Table 3.8; Table 3.9.

* Includes mining

** Percentages of Government Bonds Outstanding

Clearly, the low levels of incomes in Jordan, as well as in other developing countries, made it very difficult for individuals to save a sufficient part of their incomes and then divert it into financial investments.

Taking the monetization ratio as an indicator of the degree to which the economy permitted the accumulation of financial savings (at the expense of holding wealth in non-financial forms), Jordan showed noticeable progress in this area. The Jordanian monetization ratio averaged around 48% throughout the period under review, rising from 33.4% in 1964 to 55.7% in 1972. This was higher than any ratio achieved by the 31 African countries included in Arolow's study, in which Egypt recorded the highest ratio of 39.5%.(1) However, whereas achieving a high monetization ratio allows for further accumulation of savings in financial forms, this does not necessarily mean that such savings are made available for capital market activities. A large part of the monetized assets may be held in short-term, liquid forms, which do not increase the demand for capital market instruments. This was the general case in Jordan as reflected in the last two indicators, which clearly revealed the investment psychology among Jordanians, who exhibited a strong liquidity preference and risk-aversion that dominated the pattern of their financial investment during this period.

As typical individual investment behaviour in a developing country, Jordanians' investment portfolio during this period placed a high emphasis upon liquidity, and showed extreme reluctance towards holding long-term, risky financial assets. The investment attitude of the mass of savers remained traditional, in the sense of preferring forms of assets that involved a high degree of safety and liquidity, rather than investing

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(1) Arolow, op.cit. P.424

their savings in more sophisticated and risky forms of wealth. Wai and Patrick pointed out that such extremely cautious investment behaviour is inherited in the particular environment of a developing country, and can be changed only gradually during the course of economic and financial development.(1) As an economy grows, sequential phases of financial development occur: firstly, the monetization of economic activities takes place at the expense of barter and, secondly, the commercial banking system emerges as the main source of financial activity and then, finally, a specialised network of different long-term financial institutions develops and expands to dominate the financial structure. To-day's developing countries have not yet reached the final stage of financial development that has been attained by developed countries. Thus, the absence of relatively active institutional machinery dealing in long-term financial instruments narrows the opportunity for developing such assets. The largest part of individuals' financial savings are kept in liquid forms, either in cash hoarding or in deposits with commercial banks. Moreover, the low level of incomes prevailing in these countries further intensifies liquidity preference among the investing public. As circumstances change during the development process (due mainly to rising per capita incomes and expanding financial institutions), investors' behaviour gives less importance to liquidity and greater weight to yield, thus shifting towards investment in risky and long-term capital market instruments.(2)

Thus, the relatively small degree of economic as well as financial development attained by the country, and continuous political instability experienced during this period, worked together to intensify the willingness of Jordanians to hold their financial wealth in liquid forms.

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(1) Wai and Patrick, op.cit. PP.276-280

(2) Ibid.

The small contribution of quasi-money to total money supply (averaging around 21.8%) was a clear reflection of liquidity preference among Jordanians who were averse to holding a considerable proportion of their financial assets in forms other than currency and demand deposits. Another indicator of the dominance of the short-term element in the domestic investment portfolio was the relatively limited response shown by the public to hold the long-term government development bonds, which were first introduced in 1971. As a proportion of total government debt outstanding, individuals' holdings averaged around 5.7% during the two years 1971 and 1972. This was a small percentage, especially as compared with the following period through which the public exhibited a rising willingness to invest in such long-term assets.

The above analysis clearly reveals that neither the supply of nor the demand for securities was sufficient to operate a reasonably workable stock exchange in Jordan during the period 1964 - 1972. The recommendation of the 7 Year Plan to establish a domestic stock exchange by January 1966 did not appear to be a realistic one, given the stage of economic and financial development attained by the country at that time. The 1964 Plan asked the already established Central Bank, together with other governmental departments, to prepare for the implementation of the stock exchange programme.(1) Such a recommendation came at a time when the Central Bank had just started operations, and when it itself needed expertise and qualified personnel operatives. However, the failure to respond to the Plan's recommendation was not only related to the fact that such a recommendation was too ambitious, but it was also explained

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(1) Jordan Development Board, 7 Year Programme for Economic Development, op.cit. P.345.

by the 1967 War which suspended the implementation of the Plan itself. The deteriorating economic conditions were excacerbated by further political upheavals which added to the difficulty of introducing important institutional developments in the country.

It was only in 1973 that a relative degree of political stability permitted a new era of planning economic development with the launching of the 3 Year Plan. This Plan was more realistic than its precursor as regards introducing a domestic capital market since it asked the Central Bank to study and look into the possibility of operating such a market, rather than fixing a date for its creation as recommended by the previous Plan.(1) However, serious studies started only in 1976, when the 5 Year Plan further required the Central Bank to expedite efforts to establish a domestic stock exchange with the assistance of specialised international agencies.(2) Following this, a mission from International Finance Corporation (IFC) visited Jordan, upon the request of the Governor of the Central Bank, during 1976 to study the possibility of creating such a specialised institution in the Jordanian environment. Studies prepared by the Central Bank, with the help of the mission's expertise, showed that the rising number of corporate enterprises, and the noticeable economic progress achieved by the Jordanian economy in recent years, justified the setting-up of a domestic stock exchange.(3) The IFC estimated a rough volume of JD 200 million in securities outstanding by 1980, a figure which was considered adequate to warrant the establishment of a light institutional structure for the securities market.(4) Thus, in June 1976, the provisional Law No. 31 was issued to provide the general framework for the operations of the AFM.(5) A

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(1) National Planning Council, 3 Year Development Plan, op.cit. P.46

(2) _____, 5 Year Development Plan, op.cit. P.71

(3) Hashem Sabbagh, "Amman Financial Market: Role and Objectives", op.cit. P.1.

(4) Gerard de La Fortelle, "Financial Intermediation in Jordan, A Desk Survey", (IFC: August 1976) P.36

(5) Official Gazette, Amman Financial Market Law No.31, (Amman: June 1, 1976) No. 2629.

preparatory stage of further 18 months was necessary for the Exchange to start activity, which effectively took place in January 1978. However, whether the changing economic as well as financial circumstances reasonably justified this institutional change needs to be examined.

(2) DID THE ECONOMIC AND FINANCIAL CONDITIONS CHANGE IN FAVOUR OF SETTING-UP A DOMESTIC STOCK EXCHANGE?

In order to answer this question, the supply and demand analysis employed earlier will be used together with relevant statistics that are available for the period since 1973 and can be used as indicators of the potential sources of supply and demand on the Jordanain Exchange.

The same table (10.1) reveals noticeable changes in both supply and demand factors in favour of establishing the AFM, as compared with the previous period. As far as the potential supply of securities is concerned, all the ratios used show encouraging signs. Throughout the period 1973 - 1977, the annual rate of growth in GDP averaged around 16.9% as compared with 7.4% in the previous period, a clear indication that a higher degree of economic growth accompanied the implementation of development plans. This subsequently increased the potential supply of securities to finance economic expansion. The economy also experienced a relative structural change in favour of the manufacturing sector at the expense of the agricultural sector - another indication of rising opportunities to issue corporate securities. The table also shows that while the percentage GDP share of manufacturing output rose from an average of 10.7% to 16.4% during the two periods, the relative share of agriculture dropped noticeably from 20% to 12.5%. Not only was there a change in the country's industrial structure, but there was also a change in the organisation of Jordanian companies which encouraged capital market development. Although adequate information pertaining to type of ownership of Jordanian enterprises and their methods of financing were still lacking, recent published statistics revealed the rising significance of

the Jordanian corporate sector - a development that was necessary to widen the scope for issuing long-term financial instruments. Table 10.2 demonstrates that the subscribed capital of public shareholding companies registered at the AFM when it commenced operations accounted for JD 144.91 million, an increase of at least JD 100.88 million on the 1972 level.(1) The expanding corporate sector accompanied the implementation of various development projects implied by both plans of 1973 and 1976. This was made evident by the fact that out of the 67 public shareholding companies listed at the AFM by June 1978, 39 companies were established after 1972.(2) This, together with the encouraging changes in the aforementioned supply indicators, clearly indicated a noticeable increase in the potential supply of capital market assets during the second period under review.

Table 10.2 Development in the Subscribed Capital of Jordanian Public Shareholding Companies Between 1972 and 1977

| | 1972 | 1973 | 1977* | Changes 72 - 77 |
|---|---|---|---|---|
| Subscribed Capital (JDM) | 44.53 | 52.00 | 144.91 | 100.38 |

Source: AFM

*Figures for 1977 pertaining only to companies registered at the AFM with paid-in capital of JD 100,000 and above.

As far as the demand for such assets was concerned, all the demand factors employed earlier worked to promote the emergence of the AFM, as

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(1) The total increase in the subscribed capital should be more than this figure since only companies with a paid-in capital of JD 100,000 and above each were allowed to register at the AFM.

(2) AFM, Unpublished Statistics.

compared with their insignificant impact during the previous period. Jordanians were able to save more of their incomes - the private sector's savings/GNP ratio increased from an average of 13.4% during 1964 - 1972 to 16.6% during 1973 - 1977. The ability to accumulate such savings in financial forms was also increased as shown by the rise in the monetization ratio which increased from an average of 48% to 70% between the two periods. Moreover, investment behaviour of Jordanians exhibited a change in favour of holding long-term financial assets: firstly, the ratio of quasi-money to total money supply rose, on average, from 21.8% to 27.5% and, secondly, the relative importance of individuals' holdings of government bonds reached an average of 21.3% of total bonds outstanding, as compared with mere 5.7% during the previous period.

Clearly, the above analysis favoured the emergence of the AFM as is shown by the historical development of factors indicating the potential supply of securities and the demand for them throughout two distinct phases of economic development, covering 14 years. The creation of such an institution appeared to be necessary to institutionalise individuals' savings in long-term forms and then make them available for financing the expanding corporate sector. However, the actual performance of the AFM once it was established might not have been in line with what was envisaged. The actual levels of supply and demand could have been so limited that the net benefits accrued to the economy by establishing the AFM would be negligeable. This will now be revealed through examining the size of the AFM and levels of trading activity during one year of operations, and by comparison with relevant experiences in other developed and developing countries.

### (3) ONCE IT WAS ESTABLISHED, WHAT LEVEL OF ACTIVITY DID THE AFM CREATE AND HOW DID THIS COMPARE WITH OTHER COUNTRIES?

Table 10.3 demonstrates that trading activities on the AFM, in terms of both number and value, grew noticeably throughout 1978. The number of transactions totalled 858 in December as compared with 251 in

January, whereas the value of transactions rose from only JD 153,000 to JD 603,000 during the same period. Activity on the Exchange reached its peak during the second quarter of the year, when the number of transactions rose to 2,651 with a total value of JD 2,050,000. This could be related to the rising popularity of the AFM as reflected in the increase in both the number of companies whose shares were traded in the market and in the total number of shares traded. The former rose from 39 to 54 whereas the latter increased from 286 to 944 between the first and second quarters of the year. However, the volume of activity on the AFM during the remaining two quarters experienced a relative decline as compared with their levels in the second quarter. The value of shares traded dropped to JD 1,279,000 during the third quarter but again rose to JD 1,646,000 in the last quarter. Throughout the whole year, total transactions on the AFM numbered 8,398 with an aggregate value of JD 5,618,000. This gave an average value of JD 669 per transaction.

When capital market experiences in other countries were taken into consideration, the AFM appeared to be small in size and inactive in transactions compared to developed as well as developing countries. The comparison was made easier by the interesting comparative study of Wai and Patrick, which provided useful statistics pertaining to capital market development in a large number of countries.(1) Important stock exchange relationships indicating the size of the market and the degree of activity in both developed and developing countries are shown in Table 10.4 together with the corresponding figures of the Jordanian Market. As far as size was concerned, all adopted measures clearly showed the thinness of capital markets in developing countries (sample of 25) in comparison to their counterparts in developed countries (sample of 20). Moreover, three out of the four employed measures indicated the narrowness of the AFM, even when compared with the situation in developing countries. This was obvious in the first measure reflecting

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(1) Wai and Patrick, op.cit.

Table 10.3 Trading Activities on the Amman Financial Market, Jan. 78 - Dec. 78.

| Period | Value of Transactions JD 1000 (1) | No. of Transactions (2) | Average Value of Transaction JD (3) = (1÷2) | No. of Shares Traded (Share 1000) (4) | No. of listed Companies* (5) | No. of Companies whose shares were traded (6) | Ratio of (6) to (5) (7) |
|---|---|---|---|---|---|---|---|
| Jan 78. | 153 | 251 | 607 | 62 | | | |
| Feb. | 184 | 373 | 493 | 68 | | | |
| Mar. | 306 | 557 | 549 | 156 | | | |
| First Quarter | 643 | 1,181 | 544 | 286 | 63 | 39 | 62 |
| Apr. | 760 | 982 | 774 | 470 | | | |
| May. | 857 | 931 | 921 | 302 | | | |
| June. | 432 | 738 | 991 | 172 | | | |
| Second Quarter | 2,050 | 2,651 | 773 | 944 | 65 | 54 | 83 |
| July. | 360 | 725 | 497 | 177 | | | |
| Aug. | 425 | 733 | 580 | 231 | | | |
| Sept. | 494 | 743 | 665 | 181 | | | |
| Third Quarter | 1,279 | 2,201 | 581 | 589 | 66 | 47 | 71 |
| Oct. | 650 | 874 | 744 | 234 | | | |
| Nov. | 393 | 633 | 621 | 153 | | | |
| Dec. 78. | 603 | 858 | 703 | 221 | | | |
| Fourth Quarter | 1,646 | 2,365 | 696 | 608 | 66 | 49 | 74 |
| Total 1978 | 5,618 | 8,398 | 669 | 2,427 | | | |

Source: AFM, quarterly reports for 1978.

* Outstanding numbers at the end of each period.

the average number of companies listed, which accounted for 644 in developed countries, 172 in developing countries, and only 66 in Jordan. When relating the volume of transactions and the value of capital listed to macro-economic and monetary variables, two measures also indicate the small size of the AFM compared to developing (as well as developed) countries. The table shows that whereas the value of transactions on the Jordanian Exchange accounted for only 1% of GNP, transactions/GNP ratios were 3.2% in developing countries and 12.3% in developed countries. When the ratio of capital listed to M2 was taken as a measure, the above same result was obtained - the Jordanian ratio formed 25.3% as compared with respective ratios of 52.1% and 217.6% in developing and developed countries. It was only when the ratio of capital listed to GNP was employed as an indicator of size that the Jordanian figure yielded a slightly higher ratio than what experienced in developing countries but was, of course, much less than that of the developed countries. The table makes it clear that while the volume of capital listed on the AFM comprised about one fifth of GNP, the general experience of developing countries shows a corresponding figure of only one seventh. Both figures are much smaller than that experienced in the developed countries as a whole, where the value of capital listed on their respective exchanges is equivalent to the amount of their GNP.

Moreover, the AFM exhibited a low degree of activity as compared with the situation in developed and developing countries. This is clearly indicated by the turnover figures of outstanding securities, ratios which also reflected the popularity of stocks as an asset and their speculative use.(1) The same table demonstrates that while the Jordanian turnover ratio accounted for 5.1, the corresponding ratios for developed and developing countries averaged around 25.2 and 20.4 respectively. Although this meant that the turnover figures of outstanding securities in developing countries showed lower rates compared to

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(1) Wai and Patrick, op.cit. P.271

Table 10.4 Jordan's Important Stock Exchange Relationships As Compared With Their Counterparts In Both Developed And Developing Countries*

| | | Size Measures | | | | Activity Measures |
|---|---|---|---|---|---|---|
| | | Average No. of Companies Listed (1) | Transactions / GNP (2) | Listed Capital / GNP (3) | Listed Capital / M2 (4) | Turnover Ratio** (5) |
| A | Developed Countries (sample of 20 Countries) | 644 | 12.3 | 102.4 | 217.6 | 25.2 |
| B | Developing Countries (sample of 25 Countries) | 172 | 3.2 | 13.8 | 52.1 | 20.4 |
| | of which (1) Africa & Middle East (6 Countries) | n.a. | 3.0 | 14.4 | 45.0 | 6.5 |
| | (2) Latin Amercia (9 Countries) | n.a. | 3.0 | 9.2 | 46.7 | 12.2 |
| | (3) Asia (8 Countries) | n.a. | 3.6 | 17.4 | 60.7 | 41.6 |
| C | Jordan | 66 | 1.0 | 18.1 | 25.3 | 5.1 |

Source: (1) Jordan's figures, Amman Financial Market

(2) Other Countries' figures, Wai & Patrick, op.cit. Table 5. P.272.

* Jordan's ratios related to 1978, whereas other Countries' ratios covered 1971.

** Turnover of outstanding stocks: Transactions ÷ listed capital.

developed countries, these results should be accepted with some reservation because they represent only the general situation of countries as groups, and do not necessarily reflect individual experiences. For example, if developing countries are divided into sub-groups, Asian countries show a high turnover ratio of 41.6%, which is much above the 25.2 ratio experienced in developed countries as a whole. Such a high figure reflects, to a great extent, substantial speculations in many Asian capital markets, such as in Korea and China, where their respective turnover ratios recorded very high levels of 63 and 60 during the period 1964 - 1971.(1) As shown by the table, the Jordanian turnover figure of 5.1 is close to the ratio of 6.5 experienced in a group of African and Middle Eastern countries. However, the relatively low degree of activity on the AFM, as compared with the general situation in both developed and developing countries, is a clear sign of (a) less popularity of the stocks traded as a type of asset among other alternative forms and (b) less speculative use of such assets. Both factors worked to reduce the degree of trading on the Jordanian Exchange. The first factor reflects a continuous weak demand for capital market assets and their unfamiliarity among Jordanians, as will be now discussed. The second factor indicates the general investment behaviour of the investing public in Jordan who held stocks as an investment rather than for speculation purposes. It is believed that, as in many developing countries,(2) the majority of Jordanian purchasers of stocks keep these assets "for the long haul" as another means of holding wealth, rather than for speculating on them on the Market floor. This situation sometimes led to the absence of a particular stock in the Market where potential buyers faced difficulty in finding sellers even at good prices.

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(1) Wai and Patrick, op.cit. P.271 and 317.

(2) This seems to be the case in many developing countries where the speculative motive is less important in holding capital market assets. See: Arolow, op.cit. P.468; and Emery, op.cit. P.607.

## (4) WHY WAS THE AFM COMPARATIVELY SMALL IN SIZE AND INACTIVE IN TRADING AS COMPARED WITH ITS COUNTERPARTS IN BOTH DEVELOPED AND DEVELOPING COUNTRIES?

The comparatively small size of the AFM and the low degree of trading activity on its floor could be partly related to the newness of this institution, which has been operating only since January 1978. The previous indicators employed to measure size and activity are not ideal bases for comparison between the short experience of the Jordanian Exchange with that of the older capital markets that have been in business for many years.(1) The time factor is particularly important in comparative studies of capital markets because the development of such institutions is a gradual process through which they gain increasing popularity from both the suppliers of securities and those who demand them. Apart from this reason, however, the thinness of the AFM is explained by many factors, which can be grouped again under the forces of supply and demand. As discussed below, the relative limited supply of long-term instruments in the Market, and the weak demand made for them are the main obstacles hindering the development of the AFM. Revealing these hindrances is necessary for recommending certain official policy measures to foster and assist both sides of the Exchange.

On the supply side, the development of the AFM was restricted by the limited scope for financial instruments offered to the public. Although the AFM's Law accepted dealings in all financialassets issued by the government and other public corporations,(2) the Market has so far been confined to trading in private financial instruments. However, studies to list public debt instruments on the Exchange were

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(1) The oldest capital market in the developing countries included in Wai and Patrick's sample was the Bolsa de Comercio de lima (Peru), which was established in 1860, whereas the newest was the Malay Stock Exchange (Malaysia) which started operations in 1970. See Wai and Patrick, op.cit. Table 10, P.312.

(2) Official Gazette, Amman Capital Market Law No. 31, op.cit. Article 16.

undertaken with the assistance of the Central Bank, but have not yet been accomplished.(1) Confining trading to private financial instruments has undoubtedly minimised the volume of transactions on the AFM, and thus worked to reduce its size as compared with other countries where the government has played an active supplying role. In a sample of 13 developing countries employed by Wai and Patrick, for example, government debt instruments claimed about 32% of total new issues of securities listed on their capital markets.(2)

Moreover, even in the private sector, the scope for capital market instruments was limited only to one form, i.e. equity stocks. Although the Law permitted trading on all debt instruments issued by listed companies,(3) the Market showed no activity in such instruments because of their complete absence from the companies' borrowing practice. When they needed external finance, Jordanian commercial and industrial enterprises used to rely on either offering new capital shares or borrowing from the banking system, but never raised medium or long-term fixed-interest bonds.(4) The virtual absence of any type of debentures issued by Jordanian enterprises accordingly led to further limitation on the scope for financial instruments traded on the Exchange. When the 5 Year Plan of 1976 called upon the authorities to create the AFM, it also

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(1) Hashim Sabbagh, op.cit. P.5.

(2) Wai and Patrick, op.cit. Table 8, P.306.

(3) Official Gazette, Amman Capital Market Law No. 31, op.cit. Article 16.

(4) Given the absence of statistics pertaining to capital structure of industrial and commercial companies in Jordan, it is difficult to reveal the financial behaviour of these companies, and its effects on capital market development. This made it impossible to calculate some important financial ratios, which can indicate the extent to which these companies rely on the capital market to finance their expansion (e.g. the ratio of external finance to total funds, equity to debt ratio, etc.).

emphasised the necessity of creating incentives to promote the supply side of the market. This was done, amongst other things, by encouraging domestic enterprises to issue debt instruments in the form of long-term debentures to diversify and increase the supply of instruments offered to the public.(1) However, it will be shown that, in order to create a viable market in private fixed-interest securities, the government (through the Central Bank) should adjust the prevailing low interest rates to realistic levels in order to enable private enterprises to offer attractive bonds to the interested public.

On the demand side, demand for securities remained relatively weak which per se worked to narrow the size and limit the degree of activity in transactions. Although this situation was partly a reflection of the weakness in the supply side, since Jordanian investors were faced with a narrow array of instruments in which to invest, the demand side itself was insufficient to induce active trading on the Market. Whereas the weakness in the demand side could be generally attributed to the previously mentioned limitations which prevailed, though to different degrees, in developing countries (relatively low incomes and savings, liquidity preference, etc.), the absence of active institutional investors in the AFM further helped to keep the demand for securities at low levels. Statistics showing the type of investor in securities were not published by the AFM, but some indications clearly revealed the small influence of institutional investors in promoting the demand side of the Jordanian Exchange. In an active stock exchange, normally, capital market institutions (such as contractual saving intermediaries, mutual funds, and investment and unit trusts) constitute the major source of demand for securities, due mainly to the nature of their long-term financial obligations. In Jordan, the limited resources of some of these institutions,

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(1) National Planning Council, 5 Year Plan, op.cit. P.71.

and the complete absence of others, helped to weaken the demand side of the AFM: firstly, insurance companies and the Pension Fund were shown to have a limited role in holding capital market assets[1] and, secondly, specialised capital market institutions dealing in long-term financial instruments (mutual funds, investment companies, etc.) were still non-existent in the Jordanian Exchange. These institutions, together with contractual savings intermediaries, are the ones that give breadth, flexibility, and efficiency to the capital market.[2] The introduction and promotion of these institutions will be shown necessary for active operations on the AFM.

### (5) WHAT BENEFITS DID THE AFM OFFER TO THE ECONOMY AND WHAT WERE THE OPPORTUNITY COSTS INVOLVED IN ITS PROMOTION?

So far, the above analysis has revealed the trading activities on the AFM and the factors hampering its development, but what benefits accrued to the economy from the creation of such a specialised institution, and what were the opportunity costs involved in promoting its activities? In general, it is difficult to provide a clear-cut answer to this kind of question. Only society can decide on a matter such as this.[3] This is made even more difficult in the Jordanian case, since the very short life of the AFM precludes the possiblity of reaching a judgement on its net developmental impact. Nevertheless, an attempt will be made to indicate an approach within which an answer can be tentatively given.

To obtain the net benefits offered by the AFM, consideration of

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(1) This was mainly as a result of the small resources obtained by the former and the recent creation of the latter.

(2) David Williams, op.cit. P.215.

(3) Wai and Patrick noted that while only Society could decide whether the net benefits were worthwhile, successful experiences of capital markets (such as in Brazil) yielded considerable benefits which made the above question easy to answer. See Wai and Patrick, op.cit. P.298.

the opportunity costs implied in creating and promoting this institution must be taken into account. The opportunity costs may result from, firstly, shifting the focus of policy away from other alternative ways of mobilising savings and financing investment and, secondly, forgoing government revenues implied by providing fiscal incentives.(1) The first form does not seem to be important since financial intermediation by other monetary and capital market institutions continues to be encouraged, and the creation of the AFM tends to strengthen and diversify the intermediary function in the Jordanian economy. On the other hand, the promotion of the AFM must have involved some opportunity costs in the form of government revenues forgone. In order to encourage trading on the AFM, the Law abolished stamp duties on share selling. To reduce the cost of transactions, moreover, the Law prevented listed companies from collecting any fees on transferring ownership of shares. However, it is believed that the effect of such incentives is still nominal, and for an active promotion of the AFM, a variety of fiscal incentives (involving larger opportunity costs) need to be taken if the benefits of the AFM are to be considerable.

On the benefits side, the short period of its existence makes it difficult to precisely assess the developmental impact of the AFM, as a machinery for institutionalising savings and financing investment. It is difficult to indicate the influence of the AFM on raising the rates of aggregate savings and capital formation(2) - national accounts figures revealing both variables have not yet been published for the year 1978, in which the AFM started operations. Nevertheless, one can say that the narrow base of the AFM, and the low degree of activity on its floor, must have minimised the benefits that this institution offered to the economy. The limited size of transactions in the AFM meant

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(1) Ibid.

(2) Wai and Patrick used this measure to reveal the developmental impact of the Brazilian Stock Exchange. See Wai and Patrick, op.cit. P.297.

that only a small volume of savings were transferred through this channel towards financing investment. The small intermediary role played by the AFM is further illustrated when it is compared with the role performed by other financial intermediaries. Total transactions on the Exchange during 1978 comprised only 3% of credit outstanding of commercial banks and 7% of outstanding credit extended by specialised credit institutions. Even the small number of transactions on the Exchange were not all made available for financing new investments since the figures included both new issues together with the previously issued shares. The AFM served as a primary as well as a secondary market but statistics for dealings on each side were not available.

Although the AFM performed a limited intermediary function, it offered, at the same time, important benefits in the sense of providing an appropriate and safe environment for transacting long-term financial instruments. The existence of the AFM, and the services it offered, must have influenced the investment behaviour of individuals and encouraged them to hold capital market assets - a trend which usually manifests itself in the long-term. This favourable impact came about through two main services provided by the AFM: firstly, the creation of confidence in share investment and, secondly, the provision of liquidity. Undoubtedly, the regulatory power of the AFM must have reduced uncertainty and risk associated with share investment, thereby increasing their appeal to the public. By requiring listed companies to declare their financial situations and make this information available to the interested public, the latter's confidence in corporate shares can be promoted.(1) The influence of information flows on encouraging share investment may also occur through the regular publication of share prices on the Market floor. This has the effect of minimising the possibility of misplacing

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(1) Any company raises new funds through the Market must publish sufficient financial statistics and information in domestic daily newspapers.

individuals' savings as a result of misinformation or ignorance of real situations. Moreover, public confidence is further enhanced by the protective power that the AFM is equipped with to safeguard investors' interests, such as prohibiting manipulation of prices and punishing those who indulge themselves in forbidden activities. On the other hand, the provision of liquidity for asset holders through secondary market transactions must have encouraged public preference for share investment. Prior to the establishment of the AFM, investors had the opportunity to dispose of their shares through personal contact or local brokers who dealt with share trading as a side business - channels which frequently involved noticeable reduction in price, solely because of the need to sell. The setting-up of the AFM made it possible for investors to convert their holdings of securities through the Exchange at a reasonable price based on actual marketability of these assets, rather than being determined because of liquidity need.

However, the small intermediary role played by the AFM represented, though to different degrees, a common feature of capital market experiences in developing countries, especially during early stages of development.(1) Available studies of capital markets in developing countries all reveal that the development of these institutions is a long-term, gradual process, whereby market securities gain increasing importance and familiarity from both savers as well as investors.(2) Throughout this process, economic and financial developments induce changes favouring further encouragement of capital market institutions (in the sense of widening the scope of supplied securities and enforcing sources of demand for them). It is because of the long-term development and the accompanied future benefits that it is difficult (and also unfair) to assess the performance and impact of the AFM during its very short history.

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(1) This was the general conclusion made by the previously mentioned studies which all emphasised the limited role of these institutions as a reliable source of financing investment in developing countries. See Wai and Patrick, P.300; Arolow, P.467; and Maniatis, P.618.

(2) Ibid.

## (6) IS THE AFM FAVOURABLY SITUATED AMONG OTHER COMPETING CENTRES TO SERVE AS A REGIONAL FINANCIAL MARKET IN THE MIDDLE EAST?

Long-term benefits associated with capital market development are further expected in the Jordanian case, where government regulations appear to encourage the AFM to act as a regional financial centre in the future. The Foreign Business Control Law was amended in 1978 to attract Arab capital towards Jordanian investment, and also to allow Arab projects to raise capital in the Jordanian Market. As far as attracting funds is concerned, Arab investors (unlike other foreigners) are exempted from obtaining the approval of the Prime Minister when trading in financial instruments listed on the AFM.(1) Moreover, Arab citizens are allowed to buy listed financial assets with any currency, with the unconditional freedom to sell such assets and transfer their values abroad.(2) On the other hand, the regulations also aim at providing some facilities for Arab enterprises to raise capital in the Jordanian Exchange. Although trading on the AFM is originally restricted to domestic financial instruments, the new regulations permit other Arab countries to raise funds in the Jordanian Market, on the condition that these countries should equally allow Jordanian businessmen to obtain funds from their territories.(3)

By such measures, obviously, the government aimed to develop the AFM as a regional financial centre for Arab countries, especially

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(1) Foreign Business Control Law for 1978, Article 3-C (still unpublished in the Official Gazette).

(2) Ibid, Article 7-C.

(3) Ibid, Article 11-B.

following the outbreak of the civil war in the Lebanon with the consequent elimination of Beirut as key financial centre of the Middle East. However, this has also been the policy in Bahrain, the United Arab Emirates, Kuwait, Tunisia, Egypt, Iran, together with Greece and Cyprus who have all implemented new legislation aimed at removing a number of restrictions on foreign investment, and providing larger facilities to attract overseas funds.(1) The viability of, and the prospects for the AFM to play a regional financial role require a deep analysis and a comparative study showing the potentialities available in the Jordanian environment, and their adequacy as compared with the above mentioned competing centres. Although this is beyond the scope of the present study, it can be briefly said that the Jordanian regional financial role seems to be potentially less successful as compared to other countries, which have already been active in this field. Bahrain and the United Arab Emirates have been frequently singled out by financial specialists as the strongest candidates for replacing Beirut in providing regional financial facilities.(2) Bahrain was the first to welcome the international banking community, where 34 banks obtained permission to operate offshore business and 18 other banks were allowed to engage in full banking operations by 1977.(3) The liberal commercial and financial laws prevailing in Bahrain helped to develop the country into an offshore financial centre where international banking units were not subject to any taxation on profits or income.(4) Similar development occurred in

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(1) Thomas Kelen, "The World of Offshore Finance", The Banker, (April 1977) P.95.

(2) See the following recent articles published in The Banker: William Hall, "Bahrain's Banking Boom", (Jan. 1977) PP.69-75; Alan Moore, "A Round-up of the Financial Centres", (March 77) PP.107-115; Thomas Kelen, op.cit.; Hikmat Nashashibi, "Regional Involvement for Arab Money" (May 77) PP.33-34.

(3) Thomas Kelen, op.cit. P.95.

(4) An offshore financial centre is a place where international financial business can be carried on in a fiscally neutral way, i.e. without being subject to any domestic foreign exchange control or taxation, Bahrain imposes no exchange control or withholding taxes, nor does it have any personal or corporate taxes. See Kelen, op.cit. P.93 & 95.

the United Arab Emirates which competed with Bahrain in attracting offshore banking units to form the nucleus of a regional financial centre. In addition to the fact that this country had similar liberal commercial and financial Laws and was equipped with good telecommunication facilities, it represented a potentially richer centre (due to its larger oil income) than neighbouring competitor, Bahrain.(1) Commentators have emphasised these two countries as the strongest potential rivals, without any reference to Jordan.(2) One can therefore say that the relatively less liberal commercial and financial policies in Jordan, together with its poor domestic financial resources, compared with the above two oil-producing countries, minimise the opportunity for the AFM to assume a regional financial centre. The fact that Jordan is a confrontation state with Israel may give the two remote Gulf states further advantages over Jordan, in the sense of providing a relatively more stable and safe environment for attracting capital.

(7) GIVEN THE LIMITED DEVELOPMENTAL IMPACT OF THE AFM, HOW CAN THIS BE IMPROVED AND WHAT POLICY MEASURES NEED TO BE INTRODUCED TO MAKE THE NET BENEFITS OF THIS INSTITUTION WORTHWHILE?

It has already been illustrated that the development of capital market institutions is a long-term gradual process that takes place during the course of economic and financial development. However, such a process could be fostered and hastened by promotional government policies that proved effective in other developing countries. Although circumstances are different from one country to another, the similarity in the nature of problems facing capital market development in developing economies (resting on supply and demand forces) makes it possible to

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(1) Kathleen Bishtawi, "Caution The Catchword in UAE Banking ", The Banker, (March 1978) P.69

(2) Nashashibi, however, emphasised that Kuwait, Bahrain, and Cairo can potentially assume three different but complementary financial markets in the Middle East. He illustrated that while Kuwait is clearly developing as "in-to-out" financial centre for the region, and Bahrain as "out-to-out" centre, Cairo is gradually progressing towards a centre attracting Arab capital for domestic development. i.e. "out-to-in" centre. See H. Nashashibi, op.cit. P.34.

benefit from some successful innovation undertaken by other countries in this field. The weakness of the AFM was shown to manifest itself in the limited supply of long-term financial instruments and the insufficient demand made upon them. The proposed measures help to strengthen both sides of the Exchange, with the aim of increasing the volume of transactions and thus enlarging the benefits that this institution may offer to the economy. These measures are briefly discussed here. A fuller discussion on each point raised below will be found in the accompanying footnote references.

Firstly, Fiscal Measures.

The government can substantially improve the supply as well as the demand sides of the AFM by increasing the attractiveness of capital market assets, for both their issuers and their buyers. On the supply side, the government can further encourage the emergence of joint-stock companies (with widespread ownership of their equity capital) through tax incentives favouring this type of enterprise against normal and private shareholding companies. The Jordanian tax system subjects all shareholding companies to a unified income tax rate of 35% on profit, without differentiating between private and public shareholding companies.(1) By providing tax concessions for domestic companies to go public, the supply side of the AFM can be strengthened by offering further corporate shares to the investing public.(2)

On the demand side, tax policies may serve as a strong stimulus for individuals to hold the AFM assets. Although the Jordanian tax system encourages holdings of such assets in the sense of exempting from tax the capital gains that may accrue from the sale of securities,(3)

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(1) Hani Abou Gebara, Income Tax In Jordan (Amman: Royal Scientific Society Press, 1976) P.38. In Arabic.

(2) This was successfully experienced in Brazil, where the tax structure discriminates clearly against private companies. See Wai and Patrick, op.cit. P.295.

(3) Hani Abou Gebara, op.cit. P.22.

nevertheless, there is ample room for the effective use of tax policy to further influence asset preference of the investing public in favour of long-term financial instruments. Among a wide array of successful measures undertaken by developing countries, two are of special relevance to Jordan.(1)

(a) A substantial tax benefit to purchasers of securities can be provided by deducting from gross taxable income a certain proportion of the cost of purchasing such assets - provided that exempted securities should be held for a specific minimum period. This incentive is similar to exempting from income tax a certain percentage of income spent on life insurance premiums.

(b) More importantly, a much stronger incentive can be provided by permitting individuals and corporations to place a specified percentage of their income tax liabilities in special mutual funds - also on the condition that such subscriptions should be held for a minimum specified period. This was successfully introduced by the Brazilian Government, where the Decree-Law No. 157 of 1967 allowed 10% of individual and 5% of corporate income tax liabilities to be diverted into special mutual funds, the share of which should be held for a period between 2 - 4 years.(2) Such special mutual funds actively promoted the demand for securities since they provided about one quarter of the funds raised through the Brazilian Exchange.(3)

The adoption of the above policies by the Jordanian Government would undoubtedly involve important opportunity costs in the sense of not only reducing Treasury tax revenues,

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(1) The two recommended devices were illustrative of the Brazilian Government success in flourishing capital market development. See Wai and Patrick, op.cit. P.294. For more details, see Walter L. Ness, Jr. Financial Markets Innovation as a Development Strategy: Initial Results from the Brazilian Experience. New York University, Graduate School of Business Administration, Working Papers Series, No: 72-75 (N.Y. 1972).

(2) Walter Ness, op.cit. P.12

(3) Ibid.

but also in increasing income inequality among Jordanians.(1) The latter social cost is quite evident if one takes into account that Jordanian shareholders generally belong to middle-income and high-income groups. Despite such costs, however, it is believed that the expected benefits would be considerable, particularly through the influence of the demand incentives on AFM development. The proposed demand incentives are expected to activate and increase, to a large extent, the level of demand on the exchange made by the public as well as other institutional investors. The emergence of special mutual funds, in the manner described above, would undoubtedly improve the demand side of the Market, and help to fill an important gap in its structure represented in the absence of active institutional investors.

Secondly, Monetary Measures.

Whereas the previous fiscal incentives aim at encouraging both sides of the Exchange, the following recommendations, which can be implemented by the Central Bank, are confined only to the demand side. The Central Bank's responsibility towards the AFM lies generally in creating means and conditions most conducive to its development. Two areas of importance here are briefly discussed:

(a) Providing an appropriate environment for capital market development. To further assist and promote the demand side of the AFM, the Central Bank should create encouraging conditions capable of providing attractive yields on long-term instruments traded on the Market's floor. This can be achieved through curbing inflationary conditions and pursuing realistic interest rate policy inducive to financial development. These two issues are interrelated since the effective real return on holding financial assets depends on the prevailing rate of inflation. The effect of inflation is obvious and more serious in the case of fixed-interest

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(1) Whereas the opportunity costs in the form of government revenues foregone would result from both supply and demand incentives discussed above, the latter social cost of increasing income inequality would be mainly associated with demand incentives.

financial claims, such as saving deposits and long-term bonds, where a high rate of inflation works to lower their real yields into, sometimes, negative levels. Equities, on the other hand, are generally less influenced by the adverse effect of inflation because their prices and yields may rise with inflation. Given this explanation, it could be conceived that the recently experienced high rates of inflation in Jordan might not adversely influence the development of the AFM because it has been so far confined its trading to equity stocks. However, it is recognised that despite the theoretical explanation that share prices could benefit from inflation (because they provide better protection against price rises as compared with other fixed-interest financial claims), the equity market can also be adversely influenced by inflation, when the latter may enhance uncertainty, shorten time horizons, and create liquidity problems for companies.(1) Moreover, the adverse impacts of inflation are expected to hinder capital market development when the AFM starts to accept long-term, fixed-interest financial instruments. The future retarding effect of inflation on promoting such long-term debt instruments is further exacerbated because of the prevailing low interest rates in Jordan. It was shown in Chapter 3 that pegging interest rates to unrealistically low levels led to a negative real return on holding fixed-interest financial assets during recent inflationary years. The effect of inflation on minimising the real return on holding different types of financial assets is shown by Table 10.5 which clearly reveals that fixed-interest financial instruments are more affected by inflation as compared with equity investment. A high rate of inflation of 14.5% experienced during 1977 had considerably reduced the real return on both bank deposits and government fixed-interest bonds to negative rates of -8.7% and -6.5% respectively. The real yield of equities, on the other hand, was less influenced by inflation which had the effect

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(1) Wai and Patrick, op.cit. P.280.

Table 10.5 Nominal and Real Yields of Different Financial Assets (1977)

%

| Nominal Rates | | | Rate of Inflation | Real Rates (Nominal Rates minus inflation rate) | | |
|---|---|---|---|---|---|---|
| Fixed-Interest Assets | | Equity | | Fixed-Interest Assets | | Equity |
| Bank Deposits* | Govt.Bonds | Return on Industrial Shares** | | Bank Deposits | Govt. Bonds | Return on Industrial shares |
| 5.8 | 8.0 | 13.4 | 14.5 | -8.7 | -6.5 | -1.1 |

Source: Appendix 10.1

* Average interest on different types of deposits.

** Sample of 12 public shareholding companies listed on the AFM (See Append. 10.1)

of depressing the real return on this type of investment to -1.1%.

Given the above situation, it would be therefore difficult under the prevailing low interest rate policy and the present high levels of inflation to develop a viable market in fixed-interest debentures.(1) In order to create such a market, the Central Bank should realistically adjust the prevailing low interest rate, to enable such assets to offer attractive yields to their holders. This is particularly important if the recommendation of the 5 Year Plan of 1976 (regarding the encouragement of Jordanian enterprises to raise funds through issuing long-term bonds) is to effectively take place.

(b) Promoting an active network of institutional investors in the AFM. It has been shown that the absence of capital market institutions, handling long-term funds, is a structural deficiency in the Jordanian Exchange. To facilitate the implementation and operations of capital

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(1) This is consistent with the conclusion emphasised by Wai and Patrick regarding the effect of fixing low interest rates, in developing countries, on capital market development. See Wai and Patrick, op.cit. P.281.

markets usually, a variety of specialised institutions need to be established to mobilise long-term savings and make them available for the suppliers of securities. These institutions take the form of mutual funds, unit trusts and other investment companies that provide a basis for the development of a capital market. Such specialised institutions, together with contractual saving intermediaries, represent the major source of demand in active stock exchanges of developed countries. Even in many developing countries, capital market institutions were set-up before the creation of domestic stock exchanges.(1) The existence of institutions offering a range of investment alternatives with varying degrees of yield, risk, and maturity satisfies the different tastes of investors and thus encourages the demand for securities. There is an urgent need to create an effective demand for securities in Jordan, by setting-up specialised investment corporations to deal in long-term funds and perform underwriting functions among their activities. The previously proposed tax-financed mutual funds are expected to activate the level of demand on the Exchange. This side of the AFM can be also encouraged by promoting the emergence of voluntary (private) mutual funds, whereby the contributions of small savers can be mobilised to feed the Market with large amounts of investable funds. It is the Central Bank that is able to take the lead to create and promote an adequate machinery of capital market institutions. This is part of its larger role in promoting the country's economic development and adapting its financial structure to fit domestic development needs. The Central Bank's responsibility towards this objective is dealt with in the following chapter.

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(1) Kenya and Nigeria were cases in point. See Arolow, op.cit. P.441 and 459.

PART D

# THE CENTRAL BANKING SYSTEM

CHAPTER 11

## THE IMPORTANCE OF THE CENTRAL BANK IN PROMOTING DEVELOPMENT

Central banks in developing countries can be instrumental in promoting domestic economic development. Chapter 7 has shown that the underdeveloped financial infrastructure prevailing in such countries imposes larger responsibilities on their central banks and further requires these institutions to pursue an active monetary policy that is development-oriented.(1) Moreover, due to the failure of free market forces in these countries to attract sufficient investment funds in priority sectors, it is incumbent on the government to set up specialised financial institutions to bridge such gaps in the credit system. Furthermore, vigorous official market intervention is required in order to actively induce a change in the asset portfolio behaviour of the commercial banks in accordance with the development strategy selected. This is especially important in developing countries where, because the divergence between private and social costs and benefits in the allocation of investment is potentially greater than in developed countries, reliance on the free allocation of bank resources is more harmful from social as well as economic points of view.

However, such government market interventionist policies are usually implemented by central banking institutions, which are suitably geared for this purpose. Given their unique position as government agencies on the one hand, and their supervisory power over the financial system on the other, these institutions can greatly influence the allocation of bank resources in favour of development. Central banks' responsibility in directing the flow of financial resources towards developmental areas is even greater in countries which inherited a colonial banking system and practices that became irrelevant to post-independence conditions and requirements. This situation further requires these institutions to act positively, rather than passively, to adjust the financial system and bring

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(1) See Chapter 7, PP. 205 - 206

its operations in line with the changing domestic needs. In such circumstances, central banks must pursue policies, procedures, and follow other institutional innovations that promote the achievement of this end. Firstly, they have to make sure that they always provide appropriate conditions and financial environments most conducive to economic development. Secondly, they have to make sure that financial institutions are operating within the general framework of domestic development programmes, and their activities are consistent with the defined development strategies.

When it was established in 1964, the Central Bank of Jordan (CBJ) inherited an underdeveloped financial system dominated by colonial banking practices from its predecessor, the Jordan Currency Board (JCB). Since then, the crucial task of the CBJ has been to influence the country's financial system and adjust it completely to different requirements necessitated by shifting towards domestic development. Although the creation of the CBJ was concomitant with the adoption and implementation of the 7 Year Plan (1964 - 1970), serious involvement in development started only in 1973, when the country adopted the 3 Year Plan (1973 - 1975). Such a delay can be largely related to the earlier period of political instability following the 1967 War, which hindered the implementation of the 7 Year Plan itself, and also the readjustment processes of the financial system.(1)

The extent to which the CBJ succeeded in its readaptation task and the factors hampering the pursuit of effective monetary management were fully discussed in my M.A. Thesis, where it was shown that it achieved only partial success in influencing the country's financial system and

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(1) For the impacts of the War on the Jordanian financial system, see Chapter 2, P. 24

reorienting its activities towards internal development needs.(1) This chapter seeks to investigate and identify those areas where central banking policies and innovations can be usefully employed in Jordan to overcome the readjustment problem. To begin with, however, it is necessary to briefly outline the aforementioned limited success that was achieved to establish a background for the innovational policies that are to be recommended later. This can be outlined in the following four main areas:-(2)

(a) A major achievement of the CBJ was the repatriation of overseas funds for investment within the country itself. As a result of this action, the compositional bias of bank liquid assets was significantly changed in favour of domestic assets, particularly as compared with the previous period of the JCB when the commercial banks were free to invest abroad. Despite this, and attempts to lower the liquidity position of the commercial banks, the impact of the CBJ's procedures was limited. This situation is mainly explained by the narrow scope for domestic monetary management which made it difficult for the CBJ to effectively utilise the monetary instruments available in its armoury.

(b) Following the repatriation of overseas funds, commercial banks were compelled to seek other domestic investment avenues. Although the CBJ thereby strengthened the domestic credit base of the banks, it was only partially successful in influencing the distribution of credit, both on the sectoral side by shifting more resources to priority sectors, and on the regional side by expanding the scope for domestic credit to the remote areas of the country.

(c) The contribution of the CBJ to the creation of an adequate financial infrastructure was not satisfactory. Despite some diversification in the financial system with the setting up of a few new specialised credit institutions under the Central Banking regime, credit extended by the CBJ

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(1) J. Salah, The Evolution of the Banking System in Jordan, op.cit. Chapter 4, PP.61 - 114

(2) For more details of the performance of the CBJ, see Chapter 2 of this Thesis, PP. 36-40

to those institutions only commenced in 1971, and still constituted a small proportion of their total resources. On the other hand, the Bank's contribution to the formation of domestic money or capital markets was nominal.

(d) The CBJ partly succeeded in reducing the high economic cost of money supply creation, particularly as compared with the situation which previously prevailed under the Currency Board System. The money supply became increasingly influenced by domestic factors and less connected to external fluctuations resulting from balance of payments transactions/ Despite this improvement, however, the latter was still the dominant element in determining changes in the money supply. While this was partly explained by the limited ability of the CBJ to adjust the money supply in accordance with domestic factors, it largely resulted from the heavy reliance of Jordan on foreign aid. The considerable inflows of foreign aid received by the government had their immediate impacts on major macro-economic variables (such as GNP, consumption, savings, and investment) which accordingly induced large increases in domestic money supply.(1)

The above conclusions were based upon the CBJ's performance up to 1975. After this year, however, the Bank took a more active role in influencing the structure and operations of the financial system in accordance with the rising development requirementsaccompanying the implementation of the Five Year Plan (1976 - 1980). The Plan further required the CBJ to practise effective influence on financial institutions in order to bring their activities in line with the selected development strategies. The increasing developmental part played by the CBJ after 1975 was made evident throughout the previous chapters, when the role of each type of financial institutions was individually discussed. This partially improved the extent to which the Bank has succeeded in resolving the financial

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(1) For the significance of foreign aid in maintaining equilibrium in the Jordanian economy, see Chapter 3, PP. 53 - 59

readjustment problem, particularly in areas of diversifying and strengthening the country's financial infrastructure. As illustrated in Part C of this thesis, the CBJ paid particular attention to specialised credit institutions by extending further credit to support their financial resources.(1) Moreover, the CBJ played the leading role in establishing the Amman Financial Market which commenced operations in January 1978.(2) Despite this important institutional innovation, it will be shown that for the Jordanian Stock Exchange to be effective, further necessary central banking policies and procedures are still needed. However, apart from the improvement that occurred in this area, the developmental impact of the CBJ during 1975 - 1977 was not impressive, particularly as regards its control over the liquidity of commercial banks and the allocation of their resources.(3)

The above analysis reveals the fact that although the CBJ pursued a more and clearer positive role towards domestic development since 1973, this was still insufficient to resolve the financial readjustment problem. In today's developing countries, in particular, central banks should not only expect private financial institutions to adapt their operations within the general framework of development programmes, but they have first to provide the appropriate financial environment that helps the readjustment processes to take place. It is believed that the CBJ can play a larger role if it is to participate effectively in economic development. Domestic monetary policies should be flexible and formulated in the light of the ever-changing circumstances of the economy. In designing its policies and selecting its techniques, the CBJ should greatly benefit from the hard core experience of other countries and adopt what is adaptable and necessary for the special requirements of its economy.

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(1) See Chapter 8

(2) See Chapter 10

(3) See Chapter 4, PP. 120-143

Among a large range of successful financial innovations introduced by central banks in developing countries, a selected set was found appropriate for the domestic adoption in Jordan in order to serve similar needs. It will be shown that the introduction of some of these innovations may require amendments of the prevailing laws and regulations to permit and facilitate the required changes. However, for a systematic discussion of the recommended policy measures, these are classified in two main areas where the improvement of CBJ's actions is expected to take place: namely, the mobilisation of domestic resources and their productive utilisation.

## I

## Mobilisation of Resources

The following policy recommendations aim at, firstly, effective financialisation of domestic savings and, secondly, inducing a change in the structure of the financial holdings in favour of longer-term assets. For this purpose, three important policy measures are required.

Firstly, the adoption of a flexible and realistic interest rate policy capable of creating real incentives for holding financial assets.

Jordan lacks a realistic and purposive interest rate policy capable of effectively channelling resources into the financial system, and inducing a term transformation of financial holdings. This instrument of monetary policy has not been dynamically used for such purposes. Apart from very slight increases in the deposit rate in 1976 and 1977,(1) interest rates on bank loans and deposits have been almost static throughout the period 1955 - 1977. This is a reflection of the pursuance of a conventionally low interest rate policy, whereby rates paid and charged by commercial banks have generally been controlled and suppressed by the

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(1) See Table 11.1. However, although the table reveals an earlier change in the deposit and loan rates in 1972, this might be related to inaccuracy of data, because/only it was in this year that the Central Bank began to publish regular interest rates statistics.

authorities. On the credit side, banks were subject to a maximum lending rate of 9%, which was fixed in accordance with the "Ottoman Usury Law" when Transjordan was part of the Turkish Empire. On the deposit side, the above ceiling on bank credit naturally worked to inhibit any substantial upward adjustment in deposit rates because this would have the effect of minimising the banks' profit margin. Moreover, the CBJ has been authorised by law to specify the minimum rates paid and charged by banks.(1) However, the CBJ's action in this area was restricted by the above legislative ceiling on bank lending. This situation created some rigidities within the financial system, which were inappropriate for the process of financial development, particularly during the inflationary period of 1973 - 1977. It is argued here that the changing financial and economic circumstances in Jordan necessitated the pursuance of a realistic and flexible interest rate policy capable of rewarding holders of financial assets positive real return on their savings. To achieve this, however, the above legislative obstacle fixing the maximum lending rate should be removed, in order to give sufficient manoeuvrability to the CBJ to effectively use this important instrument of monetary policy.(2)

A low interest rate policy can be operative in an environment of price stability, where a reasonable rise in prices does not endanger the real return on financial holdings. Table 11.1 illustrates that the adoption of such a policy was appropriate for the Jordanian economy during the first phase of development (1955 - 1966) where the small rise in prices (not exceeding 1.4% per annum) worked to protect the real return on bank deposits, and also enabled commercial banks to obtain a positive real reward on their lending. During this period, the annual

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(1) Central Bank of Jordan, Temporary Law No. 93 for 1966, Article 43

(2) This is what happened in Iraq, for example, where a legislation was enacted in 1970 exempting financial institutions from the 7% maximum legal limit on interest rates fixed by the Civil Law. The aim was to give the Central Bank of Iraq discriminatory powers to set and regulate the interest rates in accordance with the country's changing conditions. See Hussain, A.E., Money, Banking and Monetary Policy in Iraq, M.A. Thesis (U.K.: University of Exeter, April 1973) P.285

Table 11.1 Nominal and Real Rates of Interest on Bank Loans and Bank Deposits, 1955 - 1977

(% per annum)

| | Nominal Rates (1) | | Rate of Inflation (2) | Real Rates (3) = (1-2) | |
|---|---|---|---|---|---|
| | Bank Loans | Bank Deposits* | | Bank Loans | Bank Deposits |
| 1955 | 7.0 | 4.0 | 1.0 | 6.0 | 3.0 |
| 1956 | 7.0 | 4.0 | 1.0 | 6.0 | 3.0 |
| 1957 | 7.0 | 4.0 | 1.0 | 6.0 | 3.0 |
| 1958 | 7.0 | 4.0 | 1.0 | 6.0 | 3.0 |
| 1959 | 7.0 | 4.0 | 1.0 | 6.0 | 3.0 |
| 1960 | 7.0 | 4.0 | 1.0 | 6.0 | 3.0 |
| 1961 | 7.0 | 4.0 | 1.9 | 5.1 | 2.1 |
| 1962 | 7.0 | 4.0 | 1.9 | 5.1 | 2.2 |
| 1963 | 7.0 | 4.0 | 1.8 | 5.2 | 2.2 |
| 1964 | 7.0 | 4.0 | 1.8 | 5.2 | 2.2 |
| 1965 | 7.0 | 4.0 | 1.8 | 5.2 | 2.3 |
| 1966 | 7.0 | 4.0 | 1.7 | 5.3 | 2.3 |
| 1967 | 7.0 | 4.0 | 1.7 | 5.3 | 2.3 |
| 1968 | 7.0 | 4.0 | 0.8 | 6.2 | 3.2 |
| 1969 | 7.0 | 4.0 | 7.8 | -0.8 | -3.8 |
| 1970 | 7.0 | 4.0 | 6.1 | 0.9 | -2.1 |
| 1971 | 7.0 | 4.0 | 5.7 | 1.3 | -1.7 |
| 1972 | 9.0 | 4.9 | 7.7 | 1.3 | -2.8 |
| 1973 | 9.0 | 4.9 | 11.1 | -2.1 | -6.2 |
| 1974 | 9.0 | 4.9 | 19.4 | -10.4 | -14.5 |
| 1975 | 9.0 | 4.9 | 11.9 | -2.9 | -7.0 |
| 1976 | 9.0 | 5.6 | 15.3 | -6.3 | -9.7 |
| 1977 | 9.0 | 5.8 | 14.5 | -5.5 | -8.7 |
| Average 55 - 66 | 7.0 | 4.0 | 1.4 | 5.6 | 2.6 |
| Average 67 - 72 | 7.3 | 4.2 | 4.9 | 2.3 | -0.7 |
| Average 73 - 77 | 9.0 | 5.2 | 14.4 | -5.4 | -9.2 |

Source: Official published statistics on interest are only available since 1972. Prior to this year, data were obtained from: Y. Sukar, The Structure of Interest Rates in Jordan, Central Bank of Jordan's publications (Nov. 74) P.10. Figures for the period after 1972 see, CBJ's Monthly Bulletins.

* Average interest on different types of deposits

real loan rate accounted for 5.6%, whereas the real deposit rate averaged around 2.6% a year. However, this was changed during the second phase (1967 - 1972) which experienced mild inflation with the increase in prices averaging 4.9% per annum. Since both lending and deposit rates remained low (the former rose by an average of only 0.3% whereas the latter increased by only 0.2% a year), their real rates were naturally reduced by the rise in prices. Inflation creates a discrepancy between nominal and real interest rates equal to the rise in prices. As shown by the table, the real deposit rate was even depressed to a negative level (-0.7%) whereas the real lending rate was reduced from 5.6% to 2.3%. This situation became increasingly worse during the last phase of development (1973 - 1977) which witnessed high inflationary pressures with the annual rate of inflation reaching 14.4% per annum. The continued adoption of low interest rate policy, in such a high inflationary environment, naturally led to further depression in the real lending and deposit rates which accounted, on average, for negative annual rates of -5.4% and -9.2% respectively (see Figure 11.1). Although the CBJ's action in 1976 to specify a 'floor' rate on saving accounts held by commercial banks led to a 1% average increase in the deposit rate, as compared with the preceding period, this was too small to protect the real yield of such assets. However, if the CBJ had desired to impose, or to promote, further rises in the deposit rate, this could have been frustrated by the prevailing legislative ceiling on bank lending. As clarified by the table, the nominal loan rate during 1973 - 1977 reached the fixed maximum of 9%, meaning that commercial banks were unable to offer a positive real return on deposits and, at the same time, maintaining a profitability margin sufficient to keep them in business.

Chapter 3 has shown that, despite the noticeably negative real yield of bank deposits, Jordanians exhibited a surprising and increasing desire to hold such assets in their portfolio, as reflected in the

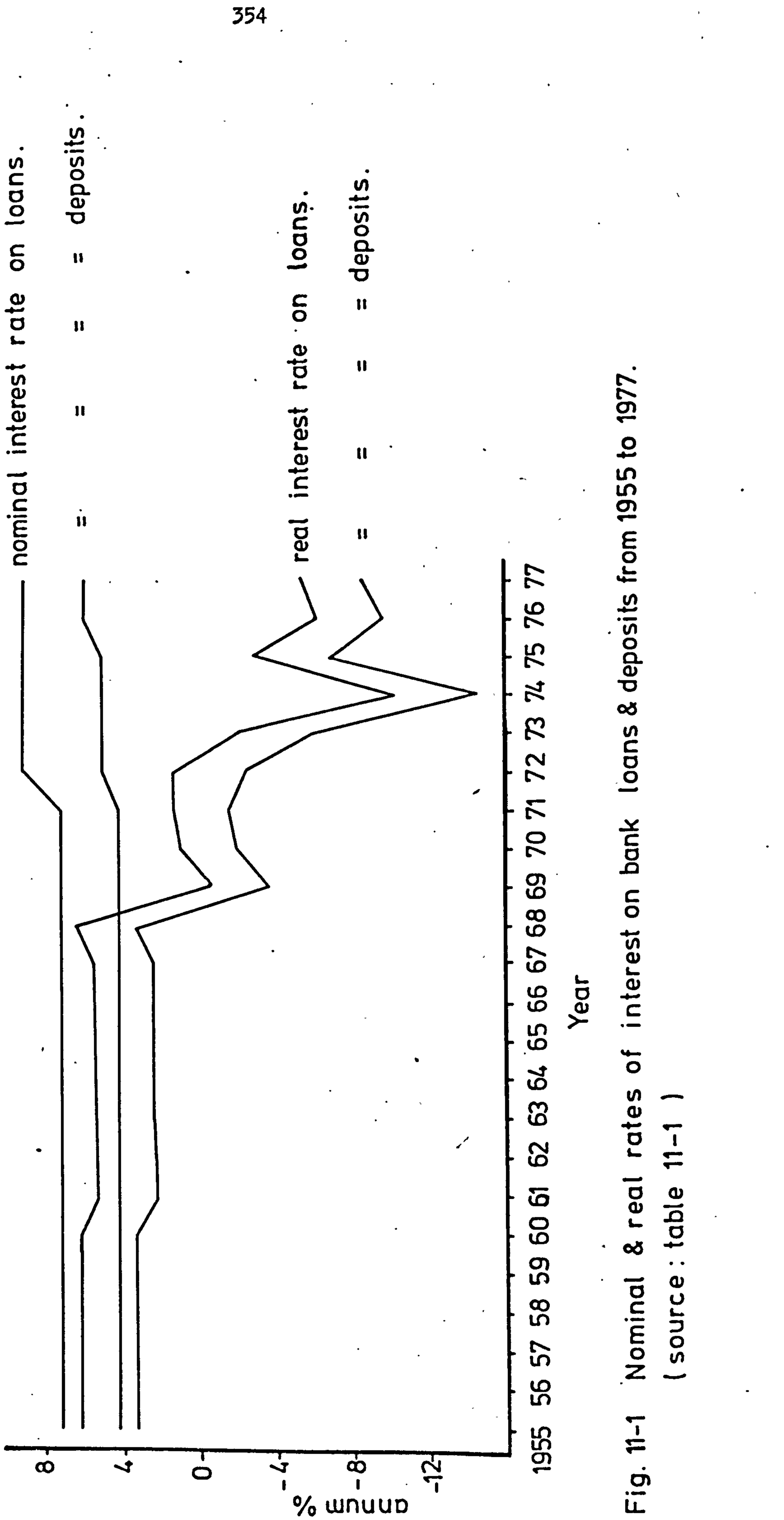


Fig. 11-1 Nominal & real rates of interest on bank loans & deposits from 1955 to 1977.
( source : table 11-1 )

continued rise in the financial intermediation ratio (M2/GNP). The possible reasons explaining such behaviour were discussed there, emphasising that the monetary authorities should not be misled by the slow adjustment process on the part of the investing public, which was accustomed to a prolonged period of price stability. It was emphasised that if people continue to receive increasingly negative returns on their financial savings, it is very likely that they will shy away from this type of investment, and channel their savings towards more profitable real estate and other speculative transactions. This may lead to financial disintermediation as happened in Argentina and Brazil, for example, when people gave up holding their savings in financial forms, thus causing a financial decline and a serious retarding effect on real economic growth.(1) Although both countries witnessed higher inflationary rates comparing with the rates experienced in Jordan, one cannot ignore the very possible reaction of Jordanians if the real value of their financial savings continues to be substantially undermined by inflation. The monetary authorities, it is believed, should not wait for the occurrence of a similar situation where people lose confidence in financial holdings and then take actions, rather it must prevent the possiblity of the financial disintermediation process to take place, by offering positive and attractive rates of return on financial savings.

Apart from the existence of the Ottoman Usury Law, the desire of the authorities to minimise the cost of investment seemed to be another factor behind the maintenance of low and stable interest rate policy in Jordan.(2) This is consistent with the general experience in developing

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(1) Walter Ness, "Some Effects of Inflation on Financing Investment in Argentina and Brazil," In Arnold Sametz, ed., Financial Development and Economic Growth (New York: New York University Press, 1972) P.234

(2) The religious factor might have discouraged attempts by the authorities to raise interest rates. Given the traditional belief of many Moslems that interest is usury , the upward adjustment of rates of interest might provoke this category of people.

countries where interest rate policy has been conventionally used as a means of regulating the cost and availability of credit (loan rate) rather than as a tool for promoting savings (deposit rate).(1) However, such a traditional bias towards low rates of interest became increasingly irrelevant to the changing circumstances in most developing countries (including Jordan) which experienced high rates of inflation. This new development made it impossible to ignore the other side of interest rate policy (deposit rate) since the continued adoption of low rates of interest in inflationary conditions might endanger the process of financial intermediation. Recent literature on interest rate policies emphasised the significance of this monetary instrument in combating inflation and mobilising financial resources.(2) Although this new trend does not overlook the significance of the credit aspect of interest rate policy, it places greater emphasis on the deposit side. A purposive interest rate policy, it is emphasised, has to reconcile the conflicting requirements of rates that are appropriate to the desired level and composition of investment, and also attract enough to stimulate savings.(3) It is such a policy that the CBJ should look for. Domestic interest rates in Jordan should be positive in real terms and flexible; realistic enough to stimulate considerable savings but not too high to inhibit internal investment. The experience of other developing countries in which the adoption of/ high interest rate strategy

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(1) Anand Chandavarkar, "Some Aspects of Interest Rate Policies in Developing Countries", IMF Staff Papers (March 1971) P.49; and Wai and Patrick, "Stock and Bond Issues and Capital Markets in Developing Countries", IMF Staff Papers (July 1973) P.283

(2) See Chandavarkar, op.cit; Wai and Patrick, op.cit; Ronald McKinnon, Money and Capital in Economic Development, op.cit.; Edward Shaw, Financial Deepening in Economic Development, op.cit.; Robert Emery, The Financial Institutions of South East Asia, op.cit.

(3) Anand Chandavarkar, "Some Aspects of Interest Rate Policy in less Developed Countries", op.cit. P.50

achieved substantial benefits (such as China, Korea, and Indonesia) should illuminate the way and encourage the Jordanian authorities to adopt a more flexible attitude towards interest rate policy.(1) Although the upward adjustment of interest rates would undoubtedly involve further cost in financing domestic development, the overall expected net benefits would be worthwhile. A more flexible and higher interest rate strategy in Jordan does not only aim at further financialisation of domestic savings, but it also intends to facilitate and achieve other monetary and economic objectives. The argument for innovational interest rate policy in Jordan and the expected benefits are summarised as follows:-

(1) A bolder interest rate policy can be used as an anti-inflationary instrument, on the one hand, and as an effective tool for inducing a term transformation of financial assets, on the other hand.

Raising the interest rate on bank deposits to a realistic level (capable of protecting the real yield of such assets) would alleviate inflation, in the sense of reducing the high level of consumption and changing the composition of/domestic investment portfolio away from the

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(1) The successful experience of a realistic interest rate policy in these countries is instructive on the role of a positive real return on financial holdings in achieving high levels of financial development. Their experiences should provide the Jordanian authorities, as well as other developing countries, with clear evidence for the great potentialities of a real positive interest rate policy as an effective device of institutionalising domestic savings. This does not, however, mean a strict application of what was experienced in such countries because interest rates there were raised to a very high level to encounter the then high rates of inflation. In China (Taiwan), for example, a strategy of high interest rates began in March 1950 by introducing a special system of preferential deposits carrying a rate of 7% a month (i.e. 125% per annum compounded monthly). This had the effect of increasing time deposits from only NT $ 2 million early in 1950 to NT $ 37 million by August 1950. Following this success, the authorities, while maintaining nominal rates at high levels to offer positive real return, adopted a policy of lowering such high levels progressively with the decline in inflation. The Chinese successful experience was followed by similar experiences in Korea (1965) and in Indonesia (1968). In both countries also, savers were offered positive real return where the nominal rates of interest exceeded the rate of inflation. As inflationary pressures eased, interest rates were subsequently decreased as experienced in Taiwan. See Chandavarkar, op.cit. PP.78-98.

speculative activities and towards financial holdings. Chapter 3 showed that the Jordanian economy has been characterised by a high level of private consumption which has been further intensified during the last phase of development (1973 - 1977).(1) The negative yield of financial assets led either to making it unattractive for people to save (thus consuming more), or to inducing socially 'undesirable' types of investments by diverting resources towards speculative transactions in commodities and real estate activities. Offering attractive real return on financial holdings would encourage people to save more out of their income, and would also discourage the flow of resources towards speculative and unproductive channels.

Moreover, by pursuing a flexible interest rate policy aiming at constantly providing positive real return on bank deposits, the monetary authorities can achieve improvement in two major interrelated areas:

(a) Inducing structural change in the composition of domestic liquidity in favour of quasi money. Chapter 3 clarified the very liquid nature of the Jordanian economy, in which currency in circulation accounted for more than one half of total domestic liquidity (M2) throughout the period 1955 - 1977.(2) The relative importance of quasi money in total M2 (20.2%) was shown to be very small compared with developed as well as developing countries. It was emphasised there that the inadequacy of the structure of domestic liquidity required effective and immediate actions by the monetary authorities to encourage a term transformation of M2. Central banking intervention in this area was further required when the quasi money element was found statistically significant in inducing real growth, with a high correlation ratio between quasi money/GNP and GNP per capita.(3) It is believed that the

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(1) See Chapter 3, PP. 47-50

(2) Ibid. Table 3.9, P.71

(3) See Chapter 3, P.86

upward ajustment of interest rates would help the authorities to reduce the high relative weight of the currency element: people would be encouraged to 'switch' from holding idle cash balances into interest-bearing financial assets in order to get advantage of the positive real return on the latter. Since currency in hand is a non-interest-bearing financial asset, there is a precise opportunity cost in holding this type of asset, which can be measured by interest earned on other financial holdings, such as bank deposits or government bonds. Thus, raising the interest rate on deposits (and on other financial savings) to real positive levels would accordingly involve a substantial increase in the opportunity cost of holding currency. Figure 11.2 illustrates this point, showing that the real opportunity cost of holding cash (as measured by the difference between the curve of real rate of return on currency(1) and the curves of real returns on bank deposits or government bonds) would be increased with the rise of interest rates on alternative financial holdings.

(b) The expected decline in the relative importance of currency holdings would minimise inflationary pressures, because part of the excess liquidity in the economy (represented in currency in circulation) would be mopped-up by the financial system. Currency holdings are idle funds kept outside the financial system, thus representing an immediate threat to price stability: such funds are readily available for spending on consumption and other speculative activities.

(2) A higher interest rate strategy would undoubtedly enlarge the size of the organised financial market at the expense of the unorganised market, thus further promoting domestic financial intermediation.

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(1) Since nominal interest rate on currency is zero, the real interest rate on holding this asset is represented by the rate of inflation.

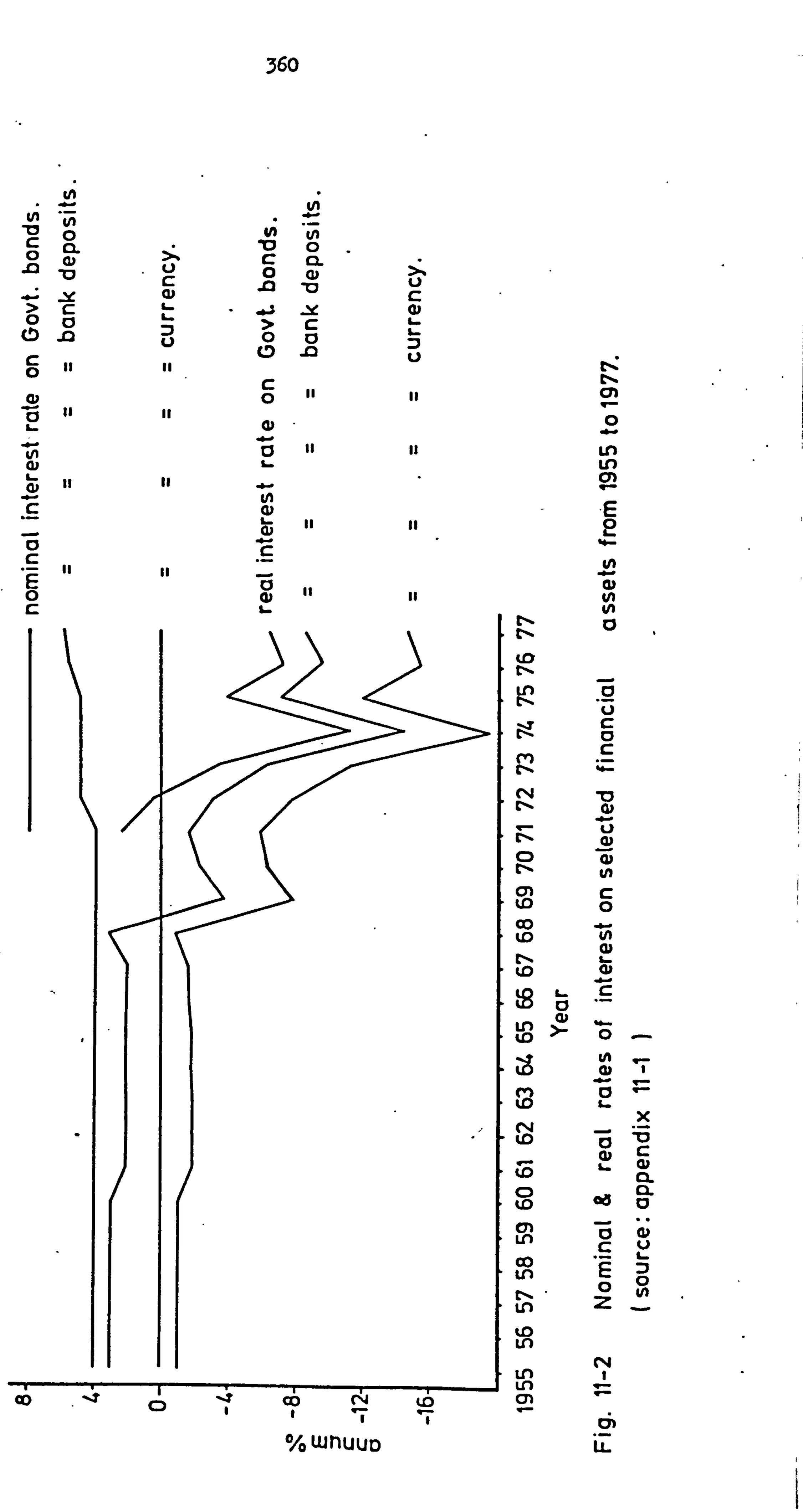


Fig. 11-2 Nominal & real rates of interest on selected financial assets from 1955 to 1977.
( source: appendix 11-1 )

The above expected reduction in the relative importance of idle cash balances, which would be attracted to the financial system, leads to the expansion of the organised financial market. The probable result of offering a positive real rate of interest in the organised sector would be to reduce the flow of resources into the unorganised sector, because the yield gap between the two sectors would be minimised. This, together with a safer environment in the organised sector, would encourage the flow of resources into the financial system, thus providing a higher degree of financial intermediation. Clearly, such a shift towards the organised financial market implies improvement in the allocation pattern of resources in favour of productive investments.

(3) Raising interest rates would enlarge the scope for domestic monetary management and expand the area of effectiveness of monetary policy.

One major problem of pursuing effective monetary policy in Jordan has been the high excessive liquidity of the economy which has been largely beyond the influence of the CBJ. It has been shown that a large proportion of M2 was held in idle currency holdings, which were difficult to control or adjust when the need rose to subject domestic liquidity to central influence. By reducing this element and expanding the organised financial sector, the scope and effectiveness of monetary policy would expand because the CBJ would be able to practise more influence on domestic asset portfolios. Moreover, the adoption of a flexible interest rate policy itself would assist domestic monetary management by adding an effective monetary tool to the already available weapons in the CBJ's armoury.

Besides reducing the excessive liquidity of the economy, a higher interest rate strategy can also encourage commercial banks to reduce their excessive liquidity holdings. This would be of special significance

for widening the scope for domestic monetary policy. The high liquidity maintained by the commercial banks has deprived the CBJ of the effective use of the discount mechanism, because commercial banks rarely resorted to the CBJ for liquidity purposes.(1) Chapters 5 and 6 revealed that commercial banks in Jordan have generally maintained high liquidity ratios, much above the minimum level prescribed and desired by the CBJ. Maintaining excessive liquidity in commercial banking was shown not only to frustrate domestic monetary management, but also to involve a considerable opportunity cost in the sense of utilising such liquid funds for financing development activities. However, it was argued there that the prevalence of low interest rate policy in Jordan could have been a factor, among others, explaining excessive liquidity holding by commercial banks.(2) Effective low real rates on bank lending must have intensified liquidity preference on the part of many banks, by further discouraging them to venture beyond the traditional lines of business, thus confining their credit to privileged and well-established borrowers. The low real ceiling on loans rate was seen by these banks to be insufficient to cover the usual administrative costs and the potential default risks involved in new lines of business.(3) Thus, by pursuing a realistic interest rate policy, the CBJ not only can practise more influence on the domestic liquidity of the economy (by reducing the currency element), but it can also encourage commercial banks to reduce their excessive liquidity holdings (by seeking new areas of business) which would eventually lead to further control on their activities.

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(1) See J. Salah, The Evolution of the Banking System in Jordan, op.cit. P.79

(2) See Chapter 6, PP. 198-199

(3) McKinnon and Shaw emphasise the above adverse effect of depressing interest rates into low levels, which deprives a large number of potential borrowers in developing countries of having an adequate access to bank credit. Their views were shown in Chapter 6, P.199

(4) A realistic interest rate policy is further required if the domestic capital market in Jordan is to expand to include trading in long-term industrial bonds.

Chapter 10 revealed the official desire to develop the Amman Financial Market (which has been so far restricted to equity trading) into a bond market. It demonstrated also that the effect of inflation is usually more serious in the case of fixed-interest financial assets (such as bank deposits and long-term bonds) as compared with its impact on equities. The real value of the former is directly undermined by inflation, whereas the latter is generally less influenced by inflation because its value and yield can rise with the increase in prices. The adverse effect of inflation on the former was further intensified in the Jordanian case, due to the adoption of a low interest rate policy which depressed the real yield of such assets into negative levels. If the Jordanian Exchange is to deal in long-term, fixed-interest financial instruments as recommended by the 5 Year Plan, then such assets should be competitive with alternative investments by yielding a reasonable real return. Pursuing a higher interest rate strategy would apply to all fixed-interest financial assets, besides bank deposits. Without protecting the real return on such instruments, it would be difficult to develop the Jordanian Exchange into an operative and active bond market.

(5) The predominance of private savings in domestic saving structure, and the relative small size of contractual savings in the private sector, create a favourable environment for the use of a higher interest rate policy to stimulate private voluntary savings.

The success of a high interest rate strategy depends largely on the extent to which domestic savings are responsive to variations in interest rates. Doubts have been raised about the interest elasticity of savings in developing countries, where the volume of savings is a function of

incomes rather than the level of interest rates.(1) However, the empirical evidence for both developing and developed countries was inconclusive in regard to the sensitivity of savings to interest rate changes.(2) Even in the U.S.A., incomes and wealth were found to be significant in determining private savings, rather than the level of interest rates.(3) Despite such disagreement on the interest elacticity of savings, it is recognised that where the size of private savings is important, and when such savings are held voluntarily rather thancompulsorily,the potentialities of the use of a higher interest rate policy to stimulate savings are greater.(4) By applying this to Jordan, a wide potential scope for interest-sensitive savings seems to be available. The relative size of the private sector in domestic savings was significant, accounting for 80% of the total during 1960 - 1972.(5) On the other hand, most of these savings were voluntarily held by the private sector - contractual savings were still of little significance in Jordan.(6) This gives more chances for a positive interest rate policy to stimulate private savings. Further, though unstatistical, evidence for the sensitivity of the Jordanian private sector to interest rate changes was clear in 1971, when the issue of government bonds, yielding interest higher than those on bank deposits (8%), led to a partial 'switch' in financial savings from the latter to the former.

(6) Finally, given the need and desirability for pursuing a flexible and positive interest rate policy in Jordan, the authorities should constantly manipulate nominal interest rates to ensure a realistic return on financial holdings. Efforts to curb inflationary pressures are of special importance here, because for fixed-interest financial

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(1) Khatkhate, D. "Analytic Basis of the Working of Monetary policy in less Developed Countries", IMF Staff Papers (Nov. 1972) P.539

(2) Chandavarkar, "Some aspects of Interest Rates policies in developing countries," op.cit. P.78

(3) Khatkhate, op.cit. P.540

(4) Chandavarkar, op.cit. P.75

(5) See Appendix 3.2 & 3.3

(6) For the limited role of contractual savings institutions, see Chapter 9

assets to offer a positive yield, there should either be relative price stability, or a change in nominal rates of interest to bring them into line with the rate of inflation. The upward adjustment of interest should not only be confined to the deposit rates, but should also cover the structure of domestic rates of interest, i.e., interest on other competing financial instruments and the lending rates.(1) The authorities can start the practical process by raising the deposit rates to a realistically positive level, i.e. one which both preserves the purchasing power of the money and provides, in addition, a reasonable rate of return.(2) Afterwards, the lending rates could be set several points higher than the average deposit rate, in order to maintain the profitability margin of the banks. Other financial instruments and the lending rates of other financial institutions could then be adjusted within a coherent overall-interest rate policy. However, the upward adjustment of rates of interest should be influenced and guided by the extent to which various economic sectors can absorb the increase in the cost of borrowing. This requires a further close examination of this important point, which can be undertaken by the CBJ before deciding upon the percentage increase in the deposit rates. If, however, the above prescribed level, to which the nominal deposit rate has to be raised, might lead to prohibitive lending rates, the former could be lowered to a level which would initially preserve the real value of deposits, with a very small real yield, or even without any yield at all. This would, at least, ensure people that the real value of their savings are not depreciating in real terms because of inflation. The aim of introducing an innovational interest rate policy in Jordan is to use such a monetary instrument positively and purposively to achieve substantial benefits for the economy as discussed above.

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(1) For the prevailing structure of interest rates in Jordan, See Appendix 11.2

(2) When inflationary pressures ease, of course, nominal rates can be subsequently lowered. However, for the above practical adjustment processes of interest rates, see Robert Emery, The Financial Institutions of South East Asia, op.cit. P.705

> "The choice is not so much between particular levels or structure of interest rates as between rigid and flexible policies".(1)

Whereas interest rate policy can be vigorously and actively used in the Jordanian context, a proper adaptation of this policy instrument to the changing economic conditions is equally necessary. On the whole, however, one has to agree with the proper application of the higher interest rate strategy as Chandavarkar puts it:

> "An appropriate overall interest rate policy for a less developed country will, however, have to be based on a delicate balancing of the requirements of rates realistic enough to stimulate saving but not too high to inhibit investment in desired channels."(2)

Secondly, the CBJ is required to introduce the system of guaranteed cheques into the commercial banking practice, since this would popularise the use of cheques as a means of payments and further promote the banking habit.

The CBJ should encourage the introduction of the guaranteed cheques system into domestic banking practice, whereby the issuing banks undertake that a maximum fixed amount of any transaction will be honoured. In the U.K., for example, the cheque card system, where a ceiling of £50 is honoured by the clearing banks, plays a significant role in providing confidence in cheques which are widely used to settle domestic transactions. Although the cheque in Jordan is protected by Law,(3) its use is still unpopular since people are usually averse to accepting it as a means of payments. Apart from cases when the drawer is known to the beneficiary, or when the latter accepts the risk of going through long administrative and legal procedures if the cheque is drawn without balance, the usual practice is to demand cash to settle everyday

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(1) Chandavarkar, "Some Aspects of Interest Rates Policies in Less Developed Countries", op.cit. P.105

(2) Chandavarkar, Anand, "Interest Rates policies in Developing Countries", Finance and Development (March 1970) P.27

(3) According to the Law, any cheque that is given to other parties without balance entails a certain period of imprisonment for the payee.

transactions. In fact, people cannot be blamed for this behaviour because the full amounts of cheques are not guaranteed by the banks. Undoubtedly, people's reluctance to accept cheques would have been much less had the banks guaranteed to pay a fixed amount per transaction. However, there is no reason why such a useful cheque guaranteed system cannot be applied in Jordan. This would effectively promote the banking habit, and further channel resources into the financial circle. The element of currency in circulation would be minimised in relative importance in total M2, a major objective that the CBJ should always endeavour to achieve.

Thirdly, Central banking action is needed not only to induce a term transformation in domestic liquidity (M2), but also to promote long-term capital market instruments by creating new institutions dealing in such assets.

It was shown in chapter 10 that one structural weakness in the Jordanian Stock Exchange was the absence of capital market institutions which usually mobilise long-term funds and make them available for investment. Active institutional investors, such as mutual funds, unit trust, and other investment companies were virtually non-existent in Jordan. Besides, contractual saving institutions (i.e. insurance companies and pension funds) were shown to be of little importance both as mobilisors of long-term savings and holders of capital market assets. This situation weakened the demand side of the Jordanian exchange, which was largely confined to individual investors. To effectively activate the demand side, the need to set up investment companies, and other private as well as public capital market institutions dealing in long-term instruments, was shown to be urgent if the Jordanian Exchange is to become an important source for financing development. The creation of such institutions is important to encourage the accumulation of long-term financial savings, which are still insignificant in the private sector asset portfolio. The CBJ, which took the necessary steps to

establish the Amman Financial Market, is also able to promote the creation of capital market institutions, yet another essential step for activating the Jordanian Exchange.

## II

## The Allocation of Resources

Whereas the previously discussed measures aim at assisting development through influencing the size and structure of domestic financial savings, the CBJ can equally promote development by operating on the allocation pattern of financial resources. The purpose of the CBJ's actions here is to exercise a closer control over bank activities, and further encourage the flow of bank funds into developmental areas.

As was shown in my M.A. Thesis, the CBJ since its inception in 1964 up to 1973 played a passive qualitative influence over bank credit.(1) Since the implementation of domestic development programmes in 1973, the CBJ has been increasingly active in domestic credit management, with the purpose of, firstly, subjecting credit under its control and, secondly, directing further resources to priority sectors. Whereas the second aspect aimed at exercising qualitative influence over bank credit to adjust it in accordance with developmental needs, the first endeavoured to restrict the expansion of credit (excluding that going to priority sectors) which increasingly contributed to domestic liquidity and to the rising inflationary pressures. Table 11.2 shows that bank credit was a major source of domestic liquidity after 1973, inducing about half of the increase in M2 during 1973 - 1977. This was compared with a corresponding figure of 22.3% during 1970 - 1972.(2) To restrict credit

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(1) J. Salah, The Evolution of the Banking System in Jordan, op.cit. P.76

(2) As Table 11.2 illustrates, net claims on the governmentwere the largest expansionary element inducing domestic liquidity between 1970 - 1972, whereas the external sector exerted a contractionary effect. The noticeably large impact of the public sector might be related to the huge government expenditures which reflected the official intention to reactivate the economy after the 1970 civil disturbances.

expansion, especially for non-essential purposes, the CBJ employed many instruments, which also aimed at influencing the allocation of bank resources in favour of development. Prior to 1975, these instruments included credit ceilings, credit/deposit ratio, and the reserves and liquidity ratios.(1) However, the application of such instruments achieved only a limited success, as credit expansion continued to endanger domestic liquidity and the sectoral distribution of credit remained heavily geared towards financing foreign trade and construction sectors (both sharing about two thirds of total credit by 1975).(2)

Monetary policy became more stringent during 1976, when credit expansion reached the highest level ever, contributing 75.9% to domestic liquidity as is shown in the table. Whereas the CBJ continued to adopt credit guidelines (whereby credit ceilings were examined and reimposed every six months) and further lowered the credit/deposit ratio,(3) new instruments were employed to influence the lending capacity of banks, together with the direction of their credit. In order to reduce the ratio of overdrafts to other types of credit facilities, commercial banks were required (during the first half of 1976) to keep with the CBJ, over and above their legal cash reserves, a special interest-bearing deposit of 3% on their overdraft to customers.(4) To further minimise the ability of banks to extend credit, a memorandum was issued in December 1976, raising the minimum liquidity ratio from the previously prescribed

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(1) For the monetary instruments employed prior to 1975 and their effect, see J. Salah, op.cit. PP 76 - 80

(2) See Appendix 4.5

(3) The 10% ceiling on credit expansion continued to operate during both halves of 1976, whereas the maximum credit/deposits ratio was reduced to 75% during the first half and to 70% during the second half. (See Central Bank of Jordan, Annual Report, 1976, PP.48-49)

(4) Central Bank of Jordan, Annual Report, 1976, P.48

Table 11.2 Factors affecting changes in Domestic Liquidity in Jordan, 1970 - 1977

(JD Million)

| | 1970 | 1971 | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | Average 70 - 72 | Average 73 - 77 |
|---|---|---|---|---|---|---|---|---|---|---|
| Changes in | | | | | | | | | | |
| 1. Domestic Liquidity (M2) | 11.02 | 3.58 | 10.48 | 28.56 | 40.68 | 60.99 | 81.18 | 80.08 | | |
| 1.1. Money (M1) | 9.24 | 2.53 | 7.03 | 24.22 | 30.97 | 48.28 | 45.08 | 51.21 | | |
| 1.2. Quasi Money | 1.78 | 1.05 | 3.45 | 4.34 | 9.71 | 12.71 | 36.10 | 28.87 | | |
| 2. Foreign Assets(net) | -1.51 | -4.04 | 7.99 | 6.35 | 9.39 | 50.49 | 17.01 | 71.24 | | |
| 3. Domestic Assets (net) | 12.53 | 7.62 | 2.49 | 22.21 | 31.29 | 10.50 | 64.17 | 8.84 | | |
| 3.1. Claims on private sector | 0.15 | 1.31 | 3.02 | 11.38 | 20.97 | 35.34 | 61.63 | 20.02 | | |
| 3.2.Claims on public corp. | -0.11 | 0.43 | 1.17 | 1.42 | 3.17 | 2.47 | 5.77 | 3.32 | | |
| 3.3. Net Claims on Govt. | 12.29 | 14.44 | -2.08 | 14.92 | 4.83 | -7.25 | 13.36 | 5.73 | | |
| 3.4. Other Items (net) | 0.20 | -8.56 | 0.38 | -5.51 | 2.32 | -20.06 | -16.59 | -20.23 | | |
| % of 2 to 1 | -13.7 | -112.8 | 76.2 | 22.2 | 23.1 | 82.8 | 20.9 | 88.9 | -16.8 | 47.6 |
| % of 3 to 1 | 113.7 | 212.8 | 23.8 | 77.8 | 76.9 | 17.2 | 79.1 | 11.1 | 116.8 | 52.4 |
| % of 3.1 to 1 | 1.4 | 36.6 | 28.8 | 39.8 | 51.5 | 57.9 | 75.9 | 25.0 | 22.3 | 50.0 |
| % of 3.3 to 1 | 11.5 | 403.3 | -19.8 | 52.2 | 11.8 | -11.9 | 16.4 | 7.2 | 165.0 | 15.2 |

Source: Central Bank of Jordan, Monthly Statistical Bulletins, (Oct. 74 & Feb. 79).

level of 30% to 32% (during the first month of the date of issue) and to 35% (during the following three months).(1) The minimum reserve requirements ratio on demand deposits was also raised from 12% to 15%, whereas that imposed on time and saving deposits remained unchanged at 12%.(2) This was the first time differential reserve requirements according to type of deposit were used in Jordan, a step in the right direction as will be shown later. Finally, the CBJ also used the interest rate instrument to increase, albeit slightly, the cost of credit by specifying a floor lending rate of 7.5%.(3)

At the beginning of 1977, however, the above restrictive measures were temporarily relaxed following the noticeable decline in general economic activity, which was largely caused by an obvious slowdown in the trade and real estate sectors.(4) Banks became generally cautious in their lending as a result of their experience with certain loans on which delays on repayment had arisen because of losses incurred by borrowers in real estate transactions, or because of the relative depression in inventories of imported goods.(5) To cope with the new situation, the CBJ suspended the previous limitations on bank credit

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(1) Central Bank of Jordan, Memorandum No. 216/76

(2) IMF, Jordan - Recent Economic Development, (Feb. 6, 1978) P.33

(3) On Jan. 1, 1976, Memorandum No.1/76 was issued to regulate the rates of interest charged and paid by commercial banks as follows: (a) the minimum prime rate of interest charged on credit facilities for financing commercial purposes shall be 7.5%. (b) The minimum rate paid on saving deposits shall range between 5% and 5½% according to type of deposit (see Central Bank of Jordan, Annual Report, 1976, P. 49

(4) Central Bank of Jordan, Annual Report, 1977, P.36

(5) IMF, Jordan - Recent Economic Development, op.cit. P.33

and the other restrictive measures adopted earlier in 1976. Credit ceilings were first suspended, then the requirement of a special deposit on overdrafts was eliminated, the maximum credit/deposit ratio was abolished, and finally the minimum liqidity ratio was resorted to its original level of 30%.(1) Commercial banks were given complete freedom in their domestic asset choice, urging them to allocate further resources towards developmental areas. However, in an attempt to encourage development finance by banks, the CBJ decided to deduct the subscriptions of these banks to the capital of the Housing Bank and the Industrial Development Bank (priority investments) from their deposits, for the purpose of calculating the capital/deposit ratio; in addition, bank assets in the form of development bonds and treasury bills (other priority investment) were also allowed to be deducted from the deposits of their customers, for the purposes of calculating the same ratio.(2)

However, despite the above increasing active role played by the CBJ in the area of credit management, the allocation pattern of bank credit has not been in line with the set development strategy of diversifying the domestic economy and strengthening its industrial base.(3) It was shown in chapter 4 that only a slight shift occurred in the sectoral distribution of bank credit in favour of agriculture and manufacturing industries, sectors of prime priority within the country's development strategies. Between 1973 - 1977, the relative importance of credit extended to agriculture rose from 3.3% to only 4.1%, whereas the proportion went in favour of manufacturing increased from 10.2% to

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(1) Central Bank of Jordan, Annual Report, 1977, P.36

(2) Ibid.

(3) For development strategies in Jordan, See Chapter 3, PP. 41-64

13.3%,[1] Bank credit was still largely confined to the foreign trade sector which managed to maintain its relative share by 1977 at the same level as in 1973 (i.e. 40.5%).[2] For commercial banks to contribute effectively to the development process, the above bias towards the traditional financing of the foreign trade sector should be radically removed, and substantial proportions of bank credit should be channelled to priority sectors in order to facilitate the required structural changes in the real economy. To achieve this, further prior planning and specification of the allocation pattern of bank resources is necessary to bring them in line with the defined development strategies. This implies a more active and vigorous selective role of credit policy within an overall "institution-related" approach of monetary policy control. As illustrated in chapter 7, an effective pursuit of this approach (where the asset portfolio behaviour of commercial banks is subjected to the desire of monetary authorities rather than being determined by the free forces of the market mechanism) is further required in developing countries in which the possible divergence between the private and social costs and benefits in the allocation of financial resources is greater than in developed countries.[3] Within this approach, two areas of central banking innovation were found appropriate and useful for domestic application in Jordan.

Firstly, an effective use of the differential reserve requirements system with the objective of influencing the asset portfolio behaviour of the commercial banks in favour of priority investments.[4]

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(1) & (2) See Appendix 4.5

(3) See Chapter 7, PP. 205 -206

(4) The author would like to mention here that some illustrative technical aspects of the selective use of this instrument were obtained from the Bank of England during the author's study visit to the Bank in April 1979. Staff from the Latin American Group (Overseas Dept.) and also from the Cashier's Office were particularly helpful in providing relevant data and also in discussing some technical sides of applying this instrument to the Jordanian environment.

As is generally recognised, the resort to a reserve requirements technique usually produces good results in the underdeveloped financial environment, where the successful application of other traditional monetary tools is limited. Since a central bank, by varying the legal required reserves, can directly influence the liquidity position of commercial banks and thus their ability to lend, this instrument can be used in developing countries as an alternative to open market operations (traditionally used in developed countries) to influence bank credit and dampen inflationary pressures.(1) However, although the CBJ frequently relied on this weapon as a main instrument of domestic credit management,(2) its application was not satisfactorily successful, because the new specified floors were always much less than the already high levels of reserves kept with the CBJ. In conditions where commercial banks maintain excessive reserves, then small changes in the required ratio would not sufficiently influence the ability of banks to reduce lending, because they can run down their excessive reserve holdings to meet the new prescribed ratios. It was shown that the actual cash reserves ratio for commercial banks in Jordan was about twice as much as the minimum legal level specified by the CBJ during 1964 - 1977.(3) This clearly suggests that for this instrument to be effective in the Jordanian context, variations in reserve requirements should be large enough to bring about the desired impact.

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(1) Furness, E., Money and Credit in Developing Africa, op.cit. P.222

(2) The reserve requirements ratio was initially fixed at 7% in Jan. 1967, then raised to 10% in Dec. 1970 and to 12% in July 1974. Recently, differential reserve requirements according to type of deposits were introduced in 1976, raising the ratio on demand deposits to 15%, whereas that on time and saving deposits remained at the same level of 12%.

(3) Whereas the commercial banks were required to maintain with the CBJ a cash ratio accounting, on average, for 10% during 1964 - 77, the actual ratio maintained was 23%, thus giving a free cash reserve ratio of 13% kept voluntarily by the banks. See chapter 4, Table 4.8, (P. 140) and also Figure 4.5.B. (P.141)

/ In developing countries, however, legal reserve requirements were used not only to exercise quantitative impact on bank credit, but also as a selective instrument aiming at changing the asset portfolio of commercial banks in favour of priority investments. A differential reserve requirements system has been successfully introduced in many developing countries, whereby different prescribed ratios were linked to the composition of commercial banks' assets in order to encourage the flow of funds into socially 'desirable' sectors. Latin American countries were particularly innovative in this area, where commercial banks were allowed to maintain a lower cash reserve ratio, provided that prescribed percentages of their portfolio consisted of specified types of loans and investments.(1) Besides influencing the asset portfolio behaviour of the commercial banks, this instrument was also used in many countries to encourage a term transformation of bank deposits. In Columbia, for example, differential reserve requirements were imposed on commercial banks, descriminating between types of deposits and, at the same time, encouraging the flow of bank funds into developmental activities. This is illustrated by Table 11.3 which shows, for instance, a higher percentage ratio on private sight deposits as compared with that imposed on saving deposits (the former being fixed at 47% whereas the latter was set at 20% as of Oct. 31, 1977). However, the latter ratio could be reduced to only 0.5% if banks allocated the difference (i.e. 19.5%) to specified categories of assets (see footnote 3 below the table). Clearly, the application of such a system would serve two important goals of monetary policy: (1) encouraging commercial banks to seek the more stable saving and time deposits

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(1) This system was extensively used in Mexico, Argentina, Columbia, Brazil, Chile, Dominican Republic, and Peru. See A. Brimmer, "Central Banking and Economic Development: The Record of Innovation", Journal of Money, Credit and Banking (Nov. 1971) PP. 787 - 789; and D. Fritz, "Measures to increase commercial bank financing of Industry in Developing Countries", Industrialisation and Productivity, Bulletin 13 (New York: U.N. Publication, 1969) PP. 93 - 95

Table 11.3 Ordinary Legal Reserve Requirements and Marginal Reserve Requirements in Columbia, 1975 - 1977

%

| | Dec.1975 | Dec.1976 | Oct.1977 |
|---|---|---|---|
| I. Ordinary Legal Reserves | | | |
| Sight Deposits and Deposits less than 30 days | 36[1] | 44[1] | 47[1] |
| Deposits of more than 30 days | 29[2] | 29[2] | 29[2] |
| Sight & Time Deposits of Public Sector Entities | 80 | 80 | 80 |
| Saving deposits of the private sector | 20[3] | 20[3] | 20[3] |
| Certificate of Deposits | 10 | 10 | 10 |
| Foreign Currency sight and time deposits | 30 | 20 | 20 |
| II. Marginal Reserve Requirements (special deposits) | | | |
| Sight Deposits and deposits less than 30 days | 100[4] | - | 100[5] |
| Certificate of Deposits | 100[4] | - | - |
| Saving Deposits | 100[4] | - | - |
| Foreign deposits coverted into local currency | - | 100[6] | 100[6] |

Source: Data were directly collected from the Bank of England (Overseas Department - Latin American Group) during a study visit in April 1979.

1 For the first col $ 100 million, the legal reserve requirements is 18%

2 Of which 14% can be held in bonds of the Industrial Financial Fund and the Caja Agravia (Priority Investments)

3 Of which 19.5% can be held in bonds of the Central Mortgage Bank (priority investments)

4 On increases of these deposits above the levels of 20-11-1975

5 On increases of these deposits above the levels of 31-1-1977. The Central Bank considers as part of these requirements any increase in banks' own resources used for their rediscount operations with the specialised funds. (Priority Uses)

6 On increases in these deposits above the levels of 22-10-1976 of which a certain percentage can be alternatively used for holding prescribed assets approved by the Central Bank.

which have a lower required reserve ratio and (2) inducing a change in the structure of bank assets in favour of priority investments.(1)

The CBJ can usefully introduce a similar system of differential reserve requirements to serve the above two purposes, which are of special concern for domestic monetary policy in Jordan. It is interesting to mention here that the CBJ's action in 1976 to fix two cash reserve ratios according to type of deposits (15% on demand deposits and 12% on saving and time deposits) would help in the application of the above suggested technique. In addition to utilising the differential reserve requirements as an inducement for commercial banks to seek longer-term savings, these banks can be also encouraged to finance priority sectors, if the CBJ extends the use of this instrument to influence bank asset portfolio behaviour. To be effective, however, the above suggested system should have two features: (1) it must be flexible to allow for necessary changes to take place when the need rises, either in the priority areas or in the prescribed percentages, and (2) the difference between the prescribed ratios and the implied incentives should be large enough to produce the expected changes, in both the structure of banks' deposits as well as in the composition of their assets.

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(1) In Mexico, for example, where differential reserve requirements have been in use for more than two decades, the authorities appeared to be satisfied with the results obtained under this system. It was felt that such a system was instrumental in encouraging banks to take an interest in types of productive loans which they had not made before because of inertia or force of habit. The authorities further believed that since banks became accustomed to extending such loans and found them to be remunerative, they might well continue this type of lending even in the absence of the imposed ratios. See Brimmer, op.cit. P.788

Moreover, the differential reserve requirements may be supplemented by marginal reserve requirements (i.e. special deposit) which can further influence the volume and direction of bank credit, particularly to serve tight monetary objectives during inflationary conditions. In addition to observing the ordinary differential reserve requirements, a central bank may also require commercial banks to maintain a certain percentage of the increase in their deposits in a special interest-bearing deposit. A special deposit scheme has been largely used in many developed countries, such as the U.K., as a quantitative instrument to exercise a direct influence on the liquidity of the commercial banks and their ability to lend. However, this can be also used as a selective instrument of credit policy to influence the flow of bank resources towards priority sectors. Special deposit schemes have been selectively used in Mexico and Columbia, in which commercial banks were required to maintain, aside from the ordinary legal reserves, marginal reserves of certain percentages on the increase in different types of deposits - however, a commercial bank may waive these requirements if it invests its new deposits in sectors and in proportions established by the monetary authorities.(1) As shown by Table 11.3, Columbian commercial banks were asked to observe marginal reserve requirements of 100% against new deposits during the period 1975 - 1977. As an alternative to maintaining this special deposit, commercial banks could hold part of the prescribed percentage in priority investment (see footnotes 5 and 6 below the table).

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(1) D. Fritz, op.cit. PP. 93 - 94

The application of marginal reserve requirements is highly recommended for the Jordanian context, especially when the CBJ pursues tight monetary policy aiming at restricting bank credit during inflationary periods.(1) More important, however, is the selective use of this weapon, as shown above, to induce vigorous change in the portfolio behaviour of commercial banks, to bring the composition of their assets within the defined and required structural changes in the real economy.(2) The direct influence and the consequent benefits of differential reserve requirements even led developed countries to selectively use this instrument to encourage commercial banks to hold a certain percentage of their resources to prescribed 'desirable' assets. A system of differential reserve requirements for selective purposes has been successfully introduced in many ECC countries (such as France, Italy, Belgium) and was also recommended for the domestic application in the U.K.(3)

Secondly, the CBJ should encourage term loans by commercial banks through (1) rediscounting longer-term financial instruments, and (2) providing incentives and imposing legislative requirements to introduce such type of lending into domestic banking practice.

The argument for, and the significance of, introducing the term lending technique into the Jordanian banking practice were fully

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(1) As particularly experienced in 1976 when bank credit generated about three quarters of the increase in domestic liquidity. Although this percentage was reduced to one quarter in 1977 (see Table 11.2), figures for 1978 revealed that bank credit resumed its large expansionary effect on domestic liquidity, inducing about three quarters of the rise in M2. (See Central Bank of Jordan, Monthly Bulletin, (Feb. 1979) Table 3.

(2) The developmental impact of this technique would be even more if the CBJ indirectly allocate part of the accumulated marginal reserves into priority sectors through further lending to specialised credit institutions.

(3) Morison and Brown, "Monetary and Credit Controls in the U.K.", op.cit. P. 1028

discussed in chapter 4, where it was shown that this type of innovation was not only necessitated by the rising need for long-term loans accompanying the implementation of development programmes, but was further encouraged by the particular structure and nature of bank deposits - about one half of these deposits had a relative stable character (in the form of time and saving deposits) whereas the other half (comprising demand deposits) had low annual turnover.(1)

However, for term lending to be undertaken by the commercial banks, it was argued, the CBJ should be first prepared to provide rediscounting facilities for long-term financial instruments when the need for liquidity rises. This has been the practice in many developing countries, such as Syria, where term lending by banks found support from the Central Bank that stood ready to rediscount medium and long-term debt instruments.(2) Jordanian central banking legislation, in fact, confines rediscounting facilities only to financial instruments not exceeding 9 months.(3) Thus, if commercial banks are to be encouraged to venture into the term lending business, the above legislative impediment should be removed to enable the CBJ to secure bank liquidity.(4) Professor

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(1) See Chapter 4, PP. 97-106

(2) United Nations, "Financing of Industrial Development of various countries in the Middle East", In: Studies on Development Problems in Selected countries of the Middle East, 1973 (New York: 1974) P.39

(3) Central Bank of Jordan, Law No. 23 of 1971, Article 39

(4) However, the CBJ may find it necessary to set up a special financial institution for rediscounting longer-termassets if term lending becomes increasingly important in bank activities. The CBJ can benefit from the Indian experience in this regard where a re-Finance Corporation has been created with the participation of the Reserve Bank of India, the government, and some commercial banks. The aim was to re-finance, through the rediscounting mechanism, any commercial bank which became financially embarrassed due to term lending operations. For more details regarding the Indian Re-Finance Corporation, see George Rosen, Some Aspects of Industrial Finance in India, op.cit. P.102

Sayers has particularly emphasised this point:

> "The upshot is that the Central Bank, though especially cautious in its own business with the general public, should adopt no rigid rule against medium-term and long-term lending by commercial banks. Even the smallest banks must lend for longer-terms than would match their assets and the Central Bank must be prepared to supply liquidity in case of emergency."(1)

In recognising the significance of the term lending technique to their economies, many developing countries modified their bank legislation to enforce this type of lending on domestic banking practice.(2) For this innovation to effectively take place in Jordan, the CBJ may find it necessary to require commercial banks, by law, to extend certain percentages of their funds to prescribed medium and long-term loans. Given a long history of strict adherence to conservatism on the part of many banks, these banks may not voluntarily undertake this type of new business. It was shown that the domestic application of this technique in Jordan does not mean a complete departure from the traditional short-term lending practice, but a partial deviation from strict orthodoxy, necessitated by the country's changing economic needs. It is therefore suggested that term lending undertaken by commercial banks should not comprise the bulk of their credit, rather it should form only a moderate proportion of their funds, which does not endanger their liquidity. The CBJ can benefit from the Greek experience where the Central Bank there fixed the required percentage of term lending at 10% of private saving and time deposits, which was later raised to 15%.(3) In the Jordanian case, the minimum required percentage can be specified by the CBJ with

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(1) R. S. Sayers, Central Banking In Underdeveloped Countries (Cairo: National Bank of Egypt, 50th Anniversary Commemoration lectures, 1956) P.10

(2) Guatemala, The Dominican Republic, Korea, Praguay, and Greece were given as examples for the enforcement of term lending on domestic bank legislations. See Chapter 4, P. 128

(3) Xenophon Zolotas, Monetary Equilibrium and Economic Development, with special Reference to the Experience of Greece, op.cit. P. 93

the co-operation of the commercial banks, and should be subject to revision in accordance with changing circumstances. Moreover, the selective role of the previously discussed differential reserve requirements system can be usefully employed here by the CBJ to encourage commercial banks to venture into this new and 'socially' desirable activity. In Columbia where such a system was extensively used, commercial banks could hold, as an alternative to maintaining the full prescribed percentage of marginal reserve requirements, a certain proportion of the required reserves in loans to industry of maturity of up to 5 years.(1) The enforcement of term lending in Jordanian bank legislations, together with the selective use of the differential reserve requirements to serve this purpose, would ensure further allocation of bank resources in long-term developmental activities.

Summary and Conclusions.

The preceding analysis has made it clear that, whereas financial intermediaries in Jordan, particularly the commercial banks, have in theory had to adjust their operations within the defined framework of development programmes, the Central Bank of Jordan has, in practice, first to provide the appropriate climate and other necessary conditions that encourage the financial adjustment processes to take place. Commercial banks, for example, cannot be expected to venture into term lending while the CBJ is not prepared to provide rediscounting facilities for longer-term financial instruments to secure their liquidity in need. It is also difficult to put blame only on the commercial banks for being unable to actively institutionalise domestic savings and lengthen their maturity, while their ability to do so is restricted by rigidities in the structure and levels of interest rates. Central banks in

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(1) D. Fritz, op.cit. P.93

developing countries should vigorously act as developmental agencies for their respective governments; they have, first of all, to pave the way and provide the conditions most conducive to financial development, then they should make sure that domestic resources are sufficiently mobilised and appropriately allocated in manners consistent with the selected development strategies. To this end, specific central banking innovations have been suggested in this chapter and their benefits have been fully discussed. Most important among these are (1) the adoption of a positive and purposive interest rate strategy aiming at influencing the size and structure of financial savings, and (2) the selective use of a differential reserve requirements system to vigorously change the composition of bank assetsin favour of developmental activities. It is believed that the active pursuit of such innovations would assist the adaptation process of the financial system and further augment the benefits of interaction between financial and economic development. As will be emphasised in the next chapter, a proper adjustment of the financial system to its special environment is particularly significant in countries, such as Jordan, where financial intermediation and the ways in which financial institutions perform their functions would well hasten or retard the process of real growth.

# SUMMARY AND CONCLUSIONS

# CHAPTER 12

## SUMMARY AND CONCLUSIONS

This thesis has analysed and assessed the activities of different types of domestic financial intermediaries within the context of Jordanian economic development. Financial policies, innovations, and procedures have been prescribed to improve the operational efficiency of the financial system and to enlarge its developmental impact.

Jordan is an example of a country where priority has been specifically given in development plans for the concomitant evolution of the internal financial structure and system as part of the means by which economic growth and structural industrial change may be effected. This policy preference therefore provides a case-study of a developing country which conforms with the special emphasis placed by recent literature on the role of financial intermediation in facilitating and attaining real economic growth. As such it may make a contribution to our knowledge of the role of the financial intermediation process in economic development.

All three Jordanian development plans - the 7 Year Plan (1964-1970), the 3 Year Plan (1973-1975), and the 5 Year Plan (1976-1980) - have emphasised the role of financial institutions in promoting real economic development.[1] This policy was a necessary complement to an overall development strategy that emphasised the continued predominant importance of the private sector in the new context of the creation of structural industrial change. To further this objective, development planners sought to encourage private sector activity and initiative by

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(1) For development strategies in Jordan and the role given to financial institutions, see Chapter 3, PP. 41 - 64

specific government investment policies. This role therefore necessitated a concomitant importance being attached to the financial intermediation process in mobilising savings and effecting the efficient developmental use of funds thereby obtained.

While each chapter of this thesis has analysed a particular aspect of the financial system, four main issues emerge as being crucial for the development of the general argument. While these are presented in the context of Jordan, the identification of these issues and the arguments that have been evolved, may also be of relevance to other less developed countries that adopt policies that emphasise the role of financial intermediation in economic development.

## ISSUE I

GIVEN A POLICY PREFERENCE THAT EMPHASISES THE ROLE OF FINANCIAL INTERMEDIATION, TWO THEORETICAL PROBLEMS NEED TO BE RESOLVED IN ORDER TO DETERMINE THE ACTUAL QUANTITATIVE SIGNIFICANCE TO BE ATTACHED TO ITS DEVELOPMENTAL CONTRIBUTION - (a) THE PRECISE RELATIONSHIP BETWEEN FINANCIAL INTERMEDIATION AND GROWTH (b) THE ACTUAL CAUSATION PROCESS UNDERLYING THIS RELATIONSHIP.

(a) Whereas the theoretical issue of whether a country's financial system can actually influence real growth has not yet been conclusively resolved, there seems to be an increasing consensus expressed in the recent literature that financial intermediaries are not in fact neutral with respect to economic development.(1) This would suggest that a country's financial structure and the operational techniques it adopts do tend to materially facilitate or retard its internal rate of real industrial progress. Given the significance attached to these institutions in the Jordanian context, the supposed link between financial intermediation and the economy's real growth needs to be statistically

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(1) See Chapter 1, PP. 5-6

established. Quantitative analysis of this relationship by means of simple regression techniques demonstrates a general significant statistical association.(1) The response of real growth (represented by GNP/capita ) to a unit change in financial intermediation (measured by M2/GNP ratio) was found statistically significant at the 1% level.

(b) Although the above empirical investigation established that financial development has accompanied real growth in the Jordanian case, it has not been possible to identify the precise direction of the causal relationship between the two variables. Chapter 1 demonstrated that, in theory, the causality of the relationship can run in either direction: economic growth can induce financial development and the latter can promote the former.(2) In practice, historical evidence of financial development in developed countries reveals the existence of two distinct types of financial systems, each having a different impact on real growth(3)-

(I) An active financial system which takes the lead in promoting economic growth through encouraging domestic entrepreneurship and direct financing of industrial expansion. Here, financial intermediation induces economic growth rather than the other way around.

(II) A passive financial system which accommodates the demand made for its services without directly initiating economic growth. Here, the financial system only responds to changes in the real economy, thus leading the direction of the relationship to run from economic to financial development. Germany was cited as an outstanding example of the former, whereas England was considered a clear example of the latter. In both cases, however, each type of financial system was successful in adapting itself to its special environment.

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(1) See Chapter 3, PP. 81 - 89

(2) See Chapter 1, PP. 7 - 10

(3) Ibid, PP. 1 -4

ARGUMENT

While aggregate analysis did not resolve the causality issue, study of the financial system in its disaggregated form led to the general conclusion that 'supply-leading' financial institutions work to direct the causal influence from financial to economic development, whereas 'demand-following' institutions tend to reverse this sequence. This study has clearly shown the existence of both types of intermediaries in Jordan operating in different areas of the financial sector. The demand-following type shaped the evolutionary pattern of the commercial banks, whereas the non-bank financial sector (except the insurance industry) followed a supply-leading approach of development. Commercial banks developed and increased in number in response to the increase in the demand made upon them by different economic units. The network of bank branches was extended to satisfy the rising demand for financial services. This was why bank offices were mainly concentrated in the Amman area, in which deposits were largely available and where loans were substantially demanded. These banks did not take the lead by establishing new branches and providing services in advance of demand, especially in rural areas where they could have been supply-leading institutions. Furthermore, they did not directly initiate economic growth in the sense of providing entrepreneurial talent, guidance, as well as finance, for the creation and expansion of domestic industries. Such activities were shown to dominate banking practice in many other countries, such as Germany and Japan. Commercial banks in Jordan, in fact, followed a similar path to that of England, where such institutions played a passive role, responding only to the demand for their services without direct initiation and promotion of growth in the real economy. Given this situation, their contribution to domestic economic development was merely confined to their role in carrying out and facilitating the

saving-investment process.

On the other hand, the non-bank financial sector in Jordan emerged and developed on a supply-leading basis. Aside from the insurance industry, which was privately initiated, the rest of the non-bank finantial institutions was created by government initiative and was further developed by official policies. These supply-leading activities must have directly promoted economic development. By setting up specialised financial institutions and providing their financial and technical services in advance of the demand for them in sectors where such facilities were either inadequate or virtually non-existent, these institutions must have taken the lead in permitting real growth to take place. The establishment of these non-bank financial intermediaries, particularly specialised credit institutions, was necessitated by the failure of the market mechanism to attract private investment in those basic sectors of the economy which were given special attention in domestic development programmes.(1) Undoubtedly, if such institutions had not been deliberately created by the government, internal development would have been greatly retarded.

CONCLUSION

The nature and direction of the causal influence between financial and real development depend largely on the type and function of the financial institution and the pattern of its evolution. The existence of both 'demand-following' and 'supply-leading' financial institutions in Jordan led to a reciprocal interaction process of influence between financial development and economic growth. In the Jordanian context, therfore, there is no unique explanation for the chain of causation.

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(1) See Chapter 8

## ISSUE II

THE ROLE OF THE COMMERCIAL BANKS. GIVEN THE INITIAL IMPORTANCE OF THE COMMERCIAL BANKS, EFFECTIVE FINANCIAL STRATEGY REQUIRES THEIR ACTIVE PARTICIPATION IN INNOVATORY CHANGES. HOW CAN THIS BE BROUGHT ABOUT?

### ARGUMENT

Despite the steady rise in both deposit/GNP ratios and banking density ratios, commercial banks had little success in three major areas[1] -

(a) Institutionalising untapped sources of savings available largely in rural and remote areas of the country (bank branches were shown to be mainly confined to the Capital and other big cities and commercial centres).

(b) Lengthening the term of the financial assets offered to the public (quasi money still constituted a very small proportion of total deposits).

(c) There was a failure to introduce innovative techniques and effective measures which could have encouraged the inflow of further resources into the banking system (the lack of active advertising campaigns and the absence of positive and attractive return on financial holdings).

As allocators of funds, banks exhibited only limited success in altering the composition of their assets to match the country's changing requirements. Asset portfolio behaviour of commercial banks has not been in line with the development strategies adopted, and has not thus actively promoted the required structural changes in the real economy. Commercial banks were, in general, averse to venturing beyond their traditional lines of business and did not, therefore, pursue innovational lending policies, which could have been instrumental in inducing the real growth of their economy. From an economic development viewpoint, three areas of functional deficiency were recognised[2] -

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(1) See Chapter 4, PP. 106-144

(2) See Chapter 4, PP. 120-145

(a) A strict adherence to the orthodox banking practice of confining credit to only short-term loans (the absence of any term lending).

(b) A continued distinct bias towards financing the foreign trade sector (the sectoral distribution of bank credit has not been sufficiently consistent with the new policy emphasis on diversifying and industrialising the national economy).

(c) An excessive liquidity maintained by commercial banks which has been unnecessarily held (thus involving considerable opportunity costs from the private as well as the social points of view). Due to the significant implications of excessive liquidity holdings for the country's economic development, the liquidity aspect of the commercial banks was further analysed (Chapters 5 and 6). A statistical model was developed to examine the influence of certain attributes and ratios within the bank balance sheet on liquidity behaviour.

CONCLUSION

Despite a noticeable increase in their contribution to domestic financial intermediation activity, the commercial banks were not entirely successful in lengthening the maturity of financial assets and altering the pattern of resource allocation in favour of priority sectors.

## ISSUE III

GIVEN THE FAILURE OF THE COMMERCIAL BANKS TO BE IN THE VANGUARD OF DEVELOPMENT FINANCE ACTIVITY, A SIGNIFICANT PART OF ANY DEVELOPMENT ACHIEVED MUST REST ON (a) THE EXISTENCE AND PROLIFERATION OF NBFIs AND (b) THESE ORGANISATIONS MUST HAVE THE VISION AND INITIATIVE TO ANTICIPATE AND FILL ANY CREDIT AND/OR INSTITUTIONAL GAPS THAT MIGHT ACT AS DEVELOPMENT BOTTLENECKS.

ARGUMENT

Non-bank financial institutions in Jordan comprise specialised credit institutions and other intermediaries operating in different areas of the financial sector. Chapters 7 and 8 emphasised the necessity of creating specialised credit institutions to fill certain credit gaps in basic sectors of the economy, which had been given priority in the country's development programmes. Six of these institutions were deliberately established by the government to specialise in financing and promoting the activities of agriculture, manufacturing, urban and rural affairs, and housing. Before the setting up of these institutions, the above sectors suffered from lack of adequate finance necessary for their development. Commercial banks were generally reluctant to extend sufficient credit to these sectors, because of the long-term nature of the credit required and also because of the high risk involved in financing such activities. In addition to their significance as gap-fillers, specialised credit institutions adopted operational criteria and performed financial and promotional functions which clearly differentiated them from ordinary commercial banks. While the activities of the latter were completely guided by profit motives, the criteria adopted by the former in selecting projects for assistence placed special emphasis on the national priority of these projects and their contribution to economic development as a whole. In contrast to commercial banks, which are usually interested in the bankable aspects of their investments, specialised credit institutions tend to combine both banking and developmental criteria when taking investment decisions.(1) The two types of intermediaries are also different from a functional point of view which further adds to the significance of the latter in economic development. As distinct from ordinary commercial banks, specialised banks are

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(1) See Chapter 7, PP. 207 -210

designed to provide both financial as well as promotional functions. It was shown that specialised credit institutions in Jordan played an important role in promoting growth in their respective sectors through providing technical assistance and managerial guidance and advice. Furthermore, the financial function itself was different in nature from that performed by commercial banks since it covered areas that have not been undertaken by the latter. Whereas the principal financial function of specialised banks was the provision of medium and long-term capital, commercial banks' lending was only confined to short-term loans. Clearly, both the nature of the financial function, as well as the technical function performed by specialised credit institutions, must have had direct promotional impact on real growth. However, it was shown that although the credit gaps in the above priority sectors have been noticeably reduced after the creation of the specialised institutions, such gaps still exist.(1) This can be related to two major factors:

(a) The insufficient degree of adaptation and the inadequacy of some operational policies pursued by specialised credit institutions. This was shown to be the case in most of these institutions, which were required to exhibit more adaptation and follow appropriate policies most conducive to the development of their respective sectors.

(b) The lack of sufficient financial resources which greatly restricted the ability of many institutions to perform their assumed developmental role. This was particularly the case in the Agricultural Credit Corporation, the Municipal and Village Loans Fund, and, to some extent, the Industrial Development Bank. It was suggested that the financial resources of these institutions can be increased not only by government contribution and central banking support, but also by tapping domestic sources of funds through offering term deposits and long-term bonds.

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(1) See the assessment of specialised credit in different sectors as shown in Chapter 8

Apart from the Housing Bank, which was active in deposit mobilisation, all specialised credit institutions showed little success in mobilising private savings. By tapping such sources of funds, specialised credit institutions can obtain further resources necessary to expand their role in promoting their respective sectors and can, at the same time, financialise part of the community's savings which may otherwise be held in unproductive forms. The introduction of long-term bonds should now be facilitated by the existence of the Amman Financial Market, which only started operations in early 1978. However, for recourse to domestic mobilisation of private savings to be effective, the yield of the above suggested debt instruments should be competitive with other alternative avenues of investment, to make them attractive for the public to hold. This would undoubtedly involve higher costs in financing investment because the lending rates of these institutions would be partly increased to reflect the rise in the cost of borrowing from the private sector. Although this would be undesirable from an economic development point of view, the overall expected benefits would be worthwhile, in the sense of substantially increasing the financial capacity of these institutions and thus their ability to bridge the credit gaps in their respective sectors, which still hamper their development. The lending rates of specialised credit institutions would, however, be raised within the higher interest rate strategy suggested for Jordan, which would affect the overall structure and levels of domestic interest rates.(1)

As far as the remaining NBFIswere concerned, these institutions were shown to be of minor importance for Jordan's economic development. Chapter 9 made it clear that the insurance industry in Jordan had little developmental impact since insurance companies were unable to mobilise substantial amounts of contractual savings and make these funds available

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(1) See Chapter 11 PP. 350 - 365

for investment in capital market assets. The other contractual saving institution represented by the Pension Fund was only recently established (1976), thus playing a limited role in capital market activities. Moreover, although postal saving facilities increasingly encouraged habitual saving trends among small savers, the volume of savings attracted by the Postal Saving Fund was too small to constitute an important source of development finance. Finally, Chapter 10 demonstrated that the recently established Amman Financial Market has not yet evolved as a significant channel for directing domestic savings towards financing investment.

CONCLUSION

The allocative function of the specialised credit institutions gave them a special significance in domestic economic development because, as development agencies, these institutions were not only interested in the profitability of their investments, but they were more importantly concerned with the economic priority of the selected projects and their overall impact on promoting growth. However, whereas the developmental impact of these institutions manifested itself in their role as allocators of funds (with little success achieved in the mobilisation side), the other non-bank financial institutions remained of limited significance for Jordan's economic development, as both mobilisors as well as allocators of funds.

ISSUE IV

GIVEN THE NECESSITY FOR, AND THE SIGNIFICANCE ATTACHED TO, THE NON-BANK FINANCIAL SECTOR IN THE COUNTRY'S SUCCESSIVE DEVELOPMENT PROGRAMMES, THE GOVERNMENT MUST PROVIDE THIS VITAL SECTOR WITH EFFECTIVE ENCOURAGING INCENTIVES.

ARGUMENT

The analysis of Part C has made it clear that the creation of the non-bank financial sector in Jordan was necessary and justified by the country's domestic needs. Successive development programmes emphasised the significance of different specialised institutions as essential instruments for achieving the overall development objectives. However, government promotional policies that have so far been taken have been insufficient to enable this sector to assume its assigned developmental role. Despite the provision of essential government legislation and the adoption of other official measures which aimed at promoting the specialised financial sector, further and more effective policies are still needed if this sector is to be an important source for financing economic development.

Benefiting largely from government experiences in other developing countries, specific tax policies were found appropriate for domestic application in Jordan, in order to offer tangible and real incentives for savers, as well as investors, to use the specialised facilities provided by this sector. On the one hand, the government can substantially influence the asset preference of the investing public in favour of long-term financial instruments, if the tax policy is effectively used to provide strong stimulus for individuals to hold such assets in their portfolio. This can be achieved by offering attractive tax benefits to holders of life insurance policies and other capital market assets, as discussed in Chapters 9 and 10.[1] In order to further encourage the demand for long-term financial instruments, the government may also permit individuals and corporations to place a specified percentage of their income tax liabilities in special mutual funds, which can be subsequently invested in capital market assets. On the other hand,

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(1) See Chapter 9, P.292 ; and Chapter 10, P.340.

the government can also induce an increase in the supply of long-term financial instruments offered to the public, by encouraging the emergence of joint-stock companies through attractive tax incentives favouring this type of enterprise, against private shareholding and normal companies. However, although the adoption of the above tax policies would clearly involve important opportunity costs in the sense of exempting the Jordanian Treasury from obtaining part of the tax revenues, the net overall benefits were shown to be considerable. It is expected that the proposed tax concessions would provide real incentives for both the holders of long-term financial assets, as well as for their issuers, which would promote the low level of activity on the Jordanian Exchange and thus augment the benefits from its existence.

## CONCLUSION

The main method of improving the contributions of NBFIsto the further development of the economy would seem to be through fiscal measures.

Finally, given the four issues raised above, considerations need to be given in the Jordanian context to the future role of the Central Bank. Since the financial system matters for the country's economic development, the CBJ should be further concerned with providing an adequate climate that is most conducive to financial development, so as to maximise the benefits of interaction between finance and real growth. Furthermore, central banking interventionist policies should be always flexible and effective in order to vigorously influence domestic financial intermediaries and adjust their activities in accordance with the selected development strategies.

This case-study has made it clear that, despite some success achieved by different types of financial intermediaries in promoting real growth in Jordan, their developmental role can still be substantially increased. Domestic financial institutions, particularly the commercial banks, have not been satisfactorily successful in adjusting themselves to their particular environment, and adapting their policies and techniques to fit the new economic needs accompanying the implementation of development programmes. An appropriate adaptation of the financial system to the special needs of its economy is very important in countries, such as Jordan, where the development of financial institutions has been relied upon to promote growth in the real economy. Moreover, the empirical finding that financial intermediation matters for Jordan's economic growth should further add to the necessity of a proper adjustment on the part of the financial system, because the way in which this system develops and the manner in which it performs its functions will affect, for the better or worse, real economic progress.

However, it was emphasised that while domestic financial institutions are required to exhibit more adaptation to the changing needs of their economy, the Central Bank of Jordan has, first, to provide an adequate financial climate that helps the readjustment processes to take place (e.g. pursuing realistic interest rate policy and providing rediscounting facilities for long-term financial instruments).(1) Moreover, the Central Bank should actively seek policies and pursue innovations capable of exercising vigorous influence over the financial system and directing its operations towards development. Chapter 11 concentrated on this aspect, and outlined certain policies and techniques to be adopted by the Central Bank of Jordan in order to achieve progress in the following two main areas -

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(1) See Chapter 11

(a) Influencing the size and structure of financial savings.

The proposed measures do not only aim at further financialisation of domestic savings, but they are also concerned with inducing a change in the structure of these savings in favour of long-term assets. Firstly, there is a need to change the composition of domestic liquidity (M2) in favour of the more stable element represented by the quasi money. Secondly, there is a need to encourage holdings of long-term financial assets offered by the non-bank financial sector. As discussed in detail, lengthening the term structure of the financial assets should be an urgent concern of the Central Bank of Jordan in order (1) to mop-up part of the excessive liquidity of the economy (largely held in cash kept outside the banks) which further accentuated inflationary pressures, and (2) to increase the availability of longer-term financial assets which can be utilised for financing long-term development needs. The necessity of encouraging a term transformation of financial assets was further supported by the empirical analysis of Chapter 3 which revealed, among other things, that the longer the maturity of the financial asset the larger the interaction between financial and real development and, thus, the greater the contribution of the financial system to the development process.(1)

(b) Adjusting the allocation pattern of bank resources in accordance with the set development strategies. It has been shown that central banking qualitative influence over the sectoral distribution of bank funds is particularly important in developing countries, where the divergence between the private and social costs and benefits in the allocation of these resources is potentially greater than in developed countries. This accordingly requires the central banks in developing countries to assume a larger developmental role in controlling and

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(1) See Chapter 3, PP. 86 - 89

influencing the asset portfolio behaviour of commercial banks in fa' of priority sectors. Thus, within an effective 'institution-related to monetary policy control, specific central bank innovatory policies were found appropriate if the composition of commercial banks' assets is to be altered in accordance with the country's development needs. The introduction of a differential reserve requirements system was particularly recommended in order to further subject bank activities under the central bank influence, and effectively encourage the flow of resources towards developmental activities.

It is hoped that this thesis will be a contribution to the current policy discussion concerning the need for new banking techniques to promote structural change in less developed countries, so that their development potential can be increased under the often severe economic and political constraints within which they have to operate.

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# APPENDICES

Appendix 3.1

## Actual and Planned Expenditures on Gross National Product, 1959-1980

(JD million)

| | Actual Figures | | | | | | | | | | | | | | Planned Figures | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | | | | | | Three Year Plan | | | | Five Year Plan | | | |
| | 1959 | 1960 | 1961 | 1962 | 1963 | 1964 | 1965 | 1966 | 1967 | 1968 | 1969 | 1970 | 1971 | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 |
| (1) Private Consumption | 87.1 | 88.4 | 102.8 | 102.4 | 116.8 | 123.5 | 138.0 | 149.6 | 158.5 | 153.4 | 166.5 | 170.0 | 182.7 | 195.9 | 204.1 | 221.4 | 238.1 | 290.0 | 310.0 | 332.0 | 355.0 | 385.0 |
| (2) Government Consumption | 25.5 | 27.0 | 28.0 | 29.0 | 33.0 | 32.2 | 36.8 | 39.2 | 46.3 | 58.6 | 64.4 | 62.5 | 62.3 | 68.6 | 74,1 | 80.0 | 86.4 | 135.0 | 146.0 | 156.0 | 165.0 | 176.0 |
| (3) Private Fixed Capital Formation | 13.0 | 13.1 | 11.5 | 14.0 | 12.8 | 12.8 | 13.5 | 15.2 | 11.6 | 14.0 | 22.7 | 17.8 | 23.0 | 17.0 | 22.9 | 25.6 | 30.9 | 74.0 | 95.0 | 86.0 | 66.0 | 62.0 |
| (4) Government Fixed Capital Formation | 5.0 | 4.5 | 5.5 | 8.1 | 7.3 | 6.0 | 10.4 | 12.5 | 15.0 | 16.0 | 16.6 | 10.0 | 15,0 | 21.0 | 35.1 | 34.7 | 29.8 | 76.0 | 86.0 | 80.0 | 77.0 | 63.0 |
| (5) Change in Stocks | -5.5 | -0.4 | 2.0 | -1.8 | - | 6.5 | 3.9 | -1.3 | -0.7 | 7.7 | 26.6 | 11.0 | 13.1 | 7.5 | - | - | - | - | - | - | - | - |
| Expenditure on Consumption & Gross Capital Formation | 125.1 | 132.6 | 149.8 | 151.6 | 169.9 | 181.0 | 202.6 | 215.2 | 230.7 | 249.7 | 296.8 | 271.3 | 296.1 | 310.0 | 336.2 | 361.7 | 285.2 | 575.0 | 637.0 | 654.0 | 663.0 | 686.0 |
| (6) Exports of Goods and Services | 11.8 | 12.8 | 16.9 | 19.1 | 20.2 | 24.6 | 28.6 | 32.0 | 27.7 | 28.3 | 32.3 | 32.3 | 23.0 | 29.2 | 32.5 | 37.5 | 45.8 | 112.0 | 136.0 | 157.0 | 196.0 | 231.0 |
| Expenditures on GDP & Imports | 136.9 | 145.4 | 166.7 | 170.7 | 190.1 | 205.6 | 231.2 | 247.2 | 257.4 | 278.0 | 329.1 | 303.6 | 319.1 | 339.2 | 368.7 | 399.2 | 431.0 | 687.0 | 773.0 | 811.0 | 859.0 | 917.0 |
| (7) Less Imports of Goods and Services | 43.4 | 47.1 | 46.6 | 51.8 | 61.0 | 56.7 | 63.6 | 76.6 | 63.7 | 91.0 | 108.7 | 89.9 | 93.3 | 97.0 | 106.6 | 114.5 | 123.0 | 306.0 | 344.0 | 342.0 | 344.0 | 346.0 |
| Expenditures on GDP | 93.5 | 98.3 | 120.1 | 118.9 | 129.1 | 148.9 | 167.6 | 170.6 | 194.7 | 187.0 | 220.4 | 213.7 | 225.8 | 242.2 | 262.1 | 284.7 | 308.0 | 381.0 | 429.0 | 469.0 | 515.0 | 571.0 |
| (8) Net Factor Income From Abroad* | 5.6 | 7.4 | 7.0 | 11.9 | 8.5 | 11.7 | 12.9 | 15.2 | 11.2 | 10.4 | 14.0 | 12.6 | 13.2 | 12.4 | 12.6 | 13.8 | 14.5 | 43.0 | 46.0 | 49.0 | 55.0 | 63.0 |
| Expenditure on GNP | 99.1 | 105.7 | 127.1 | 130.8 | 137.6 | 160.6 | 180.5 | 185.8 | 205.9 | 197.4 | 234.4 | 226.3 | 239.0 | 254.6 | 274.7 | 298.5 | 322.5 | 424.0 | 475.0 | 518.0 | 570.0 | 634.0 |

Source: (1) For the period 1959-1966, see The Hashemite Kingdom of Jordan, Dept. of Statistics, The National Accounts, 1967-1972, (Amman: Dept. of Statistics Press, May 1973) p. 71.
(2) For the period 1967-1975, see the National Planning Council, Three Year Development Plan, 1973-1975, p. 48.
(3) For the period 1976-1980, see the National Planning Council, Five Year Development Plan, 1976-1980, p. 54.

* Includes remittances from Jordanian working abroad, income from oil companies, and dividends received from abroad.

Appendix 3.2

## Actual and Projected Sources of Financing Government's Capital Expenditure, 1959-1980

(JD million)

| | Actual Figures | | | | | | | | | | | | | | Planned Figures | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | | | | | | Three Year Plan | | | Five Year Plan | | | | |
| | 1959 | 1960 | 1961 | 1962 | 1963 | 1964 | 1965 | 1966 | 1967 | 1968 | 1969 | 1970 | 1971 | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 |
| (1) Current Account Surplus (a minus b) | 4.9 | 4.1 | 3.9 | 7.3 | -0.2 | 8.8 | 2.1 | 5.6 | 24.1 | 13.2 | 0.7 | -1.7 | 4.1 | 4.5 | 3.5 | 3.6 | 3.3 | 21.0 | 27.0 | 33.0 | 39.0 | 56.0 |
| (a) Current Revenues: | 30.7 | 31.4 | 32.5 | 37.2 | 33.7 | 42.3 | 40.0 | 46.8 | 74.9 | 76.4 | 75.7 | 70.7 | 76.4 | 83.6 | 88.5 | 94.8 | 101.2 | 168.0 | 187.0 | 205.0 | 222.0 | 251.0 |
| of which (Domestic) | (13.8) | (14.9) | (16.0) | (21.8) | (20.4) | (27.8) | (28.2) | (34.4) | (29.6) | (29.5) | (35.8) | (33.9) | (39.6) | (43.6) | (48.5) | (54.8) | (61.2) | (107.0) | (126.0) | (144.0) | (161.0) | (190.0) |
| (Foreign Aid) | (16.9) | (16.5) | (16.5) | (15.4) | (13.3) | (14.5) | (11.8) | (12.4) | (45.3) | (46.9) | (39.9) | (36.8) | (36.8) | (40.0) | (40.0) | (40.0) | (40.0) | (61.0) | (61.0) | (61.0) | (61.0) | (61.0) |
| (b) Current Expenditures | 25.8 | 27.3 | 28.6 | 29.9 | 33.9 | 33.5 | 37.9 | 41.2 | 50.8 | 63.2 | 75.0 | 72.4 | 72.3 | 79.1 | 85.0 | 91.2 | 97.9 | 147.0 | 160.0 | 172.0 | 183.0 | 195.0 |
| (2) Government Bonds | - | - | - | - | - | - | - | - | - | - | - | - | 3.0 | 5.0 | 10.0 | 9.9 | 7.7 | 12.0 | 12.0 | 15.0 | 18.0 | 18.0 |
| (3) Borrowing from the Banking System | - | - | - | - | - | - | - | - | - | - | 8.4 | 4.2 | 9.1 | 0.7 | 6.6 | 6.7 | 6.8 | 7.0 | 7.0 | 7.0 | 7.0 | 7.0 |
| (4) Capital Transfers from Abroad (Tech. Assistance) | 2.6 | 3.7 | 2.7 | 2.8 | 3.2 | 6.3 | 8.6 | 11.4 | 0.8 | 0.4 | 0.5 | 0.9 | 1.4 | 2.0 | 6.0 | 5.5 | 5.0 | 3.0 | 4.0 | 4.0 | 5.0 | 5.0 |
| (5) Foreign Loans | 0.5 | 1.5 | 0.5 | 1.6 | 0.5 | 1.0 | 2.3 | 4.9 | 2.0 | 5.0 | 4.5 | 0.6 | 9.6 | 13.0 | 17.0 | 18.0 | 18.0 | 72.0 | 81.0 | 60.0 | 42.0 | 12.0 |
| (6) Total Resources available for Cap. Expend. (1-thro.4) | 8.0 | 9.3 | 7.1 | 11.7 | 3.5 | 16.1 | 13.0 | 21.9 | 26.9 | 18.6 | 14.1 | 4.0 | 27.2 | 25.2 | 43.1 | 43.7 | 40.8 | 115.0 | 131.0 | 119.0 | 111.0 | 98.0 |
| Minus | | | | | | | | | | | | | | | | | | | | | | |
| (7) Repayments of Loans & Obligations | - | - | - | - | - | - | - | - | 0.3 | 0.5 | 0.6 | 0.9 | 1.8 | 6.1 | 6.3 | 7.0 | 8.5 | 17.0 | 13.0 | 14.0 | 14.0 | 15.0 |
| (8) Loans & Grants to Private Sector | 0.5 | 0.7 | 0.3 | 0.6 | 0.5 | 0.8 | 1.6 | 1.1 | 1.0 | 3.0 | 1.3 | 1.0 | 1.1 | 1.2 | 1.7 | 2.0 | 2.5 | 22.0 | 32.0 | 25.0 | 20.0 | 20.0 |
| (9) Total Capital Expenditures | 5.0 | 4.5 | 5.5 | 8.1 | 7.2 | 6.0 | 10.4 | 12.7 | 15.0 | 16.0 | 16.6 | 10.0 | 15.0 | 21.0 | 35.1 | 34.7 | 29.8 | 76.0 | 86.0 | 80.0 | 77.0 | 63.0 |
| (10) Changes in Cash Balances (6 - 9) | 2.5 | 4.1 | 1.3 | 3.0 | -4.2 | 9.3 | 1.1 | 8.1 | 10.6 | -0.9 | -4.4 | -7.9 | 9.3 | -3.1 | - | - | - | - | - | - | - | - |

Source: (1) For the period 1959-1966, see the Hashemite Kingdom of Jordan, Dept. of Statistics, The National Accounts, 1967-1972, (Amman: Dept. of Statistics Press, May 1973) p. 71.
(2) For the period 1967-1975, see the National Planning Council, Three Year Development Plan, 1973-1975, p. 48.
(3) For the period 1976-1980, see the National Planning Council, Five Year Development Plan, 1976-1980, p. 54.

Appendix 3.3 Actual and Planned Sources of Financing Private Sectors Capital Expenditure, 1959-1980

| | Actual Figures | | | | | | | | | | | | | | Planned Figures | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | | | | | | Three Yr. Plan | | | Five Year Plan | | | | |
| | 1959 | 1960 | 1961 | 1962 | 1963 | 1964 | 1965 | 1966 | 1967 | 1968 | 1969 | 1970 | 1971 | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 |
| (1) Current Account Surplus | 2.7 | 7.0 | 12.7 | 11.0 | 5.4 | 19.4 | 19.6 | 7.8 | 26.3 | 33.3 | 44.8 | 35.2 | 28.4 | 27.7 | 34.6 | 35.5 | 36.2 | 43.0 | 55.0 | 59.0 | 72.0 | 77.0 |
| (2) Loans & Contribution From Government | 0.5 | 0.6 | 0.3 | 0.6 | 0.5 | 0.7 | 1.6 | 1.1 | 1.0 | 3.0 | 1.3 | 1.0 | 1.1 | 1.2 | 1.7 | 2.0 | 2.5 | 22.0 | 32.0 | 25.0 | 20.0 | 20.0 |
| (3) Net Foreign Loans and Investment | 0.1 | 0.4 | 0.5 | 1.0 | 0.9 | 0.2 | 0.2 | 0.3 | - | -0.1 | 0.8 | -0.1 | -0.2 | - | 1.4 | 2.6 | 3.8 | 18.0 | 18.0 | 13.0 | 12.0 | 12.0 |
| (4) Total Resources Available for Cap. Expend. (1 through 4) | 3.3 | 8.0 | 13.5 | 12.6 | 6.8 | 20.3 | 21.4 | 9.2 | 27.3 | 36.2 | 46.9 | 36.1 | 29.3 | 28.9 | 37.7 | 40.1 | 42.5 | 83.0 | 105.0 | 97.0 | 104.0 | 109.0 |
| Minus | | | | | | | | | | | | | | | | | | | | | | |
| (5) Total Capital Expend. | 7.5 | 12.7 | 13.5 | 12.2 | 12.8 | 19.3 | 17.4 | 13.6 | 10.9 | 21.7 | 48.3 | 28.8 | 36.1 | 24.5 | 22.9 | 25.6 | 30.9 | 74.0 | 95.0 | 86.0 | 66.0 | 62.0 |
| (6) Net Changes in Cash Balances (4-5) | -4.2 | -4.7 | - | 0.4 | -6.0 | 1.0 | 4.0 | -4.4 | 16.4 | 14.5 | -1.4 | 7.3 | -6.8 | 4.4 | 14.8 | 14.5 | 11.6 | 9.0 | 10.0 | 11.0 | 38.0 | 47.0 |

Source: (1) For the period 1959-1966, see the Hashemite Kingdom of Jordan, Dept. of Statistics, The National Accounts, 1967-1972, (Amman: Dept. of Statistics Press, May 1973) p. 71.

(2) For the period 1967-1975, see the National Planning Council, Three Year Development Plan, 1973-1975, p. 48.

(3) For the period 1976-1980, see the National Planning Council, Five Year Development Plan, 1976-1980, p. 54.

Appendix 3.4

## Actual and Projected Contribution of Economic Sectors to GDP, 1959-1980

(JD million)

| Sector | Actual Figures | | | | | | | | | | | | | | Planned Figures | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | | | | | | Three Year Plan | | | Five Year Plan | | | | |
| | 1959 | 1960 | 1961 | 1962 | 1963 | 1964 | 1965 | 1966 | 1967 | 1968 | 1969 | 1970 | 1971 | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 |
| 1. Agriculture | 15.08 | 14.62 | 25.30 | 20.90 | 22.08 | 34.14 | 34.11 | 27.65 | 38.74 | 27.53 | 36.34 | 28.66 | 37.81 | 42.45 | 41.10 | 43.80 | 46.90 | 32.00 | 34.00 | 36.00 | 39.00 | 42.00 |
| 2. Mining & Manufacturing | 6.23 | 6.86 | 8.83 | 8.06 | 10.62 | 12.53 | 16.22 | 17.27 | 17.50 | 20.05 | 23.12 | 19.77 | 20.56 | 25.23 | 26.80 | 30.70 | 35.50 | 67.00 | 84.00 | 95.00 | 114.00 | 144.00 |
| 3. Construction | 4.66 | 4.50 | 4.50 | 6.15 | 6.12 | 5.45 | 7.87 | 9.28 | 8.69 | 9.83 | 10.89 | 7.79 | 7.50 | 9.67 | 13.50 | 15.00 | 15.80 | 26.00 | 32.00 | 32.00 | 30.00 | 27.00 |
| 4. Electricity & Water Supply | 0.66 | 0.69 | 0.67 | 0.74 | 0.93 | 1.03 | 1.68 | 2.26 | 1.78 | 2.27 | 2.09 | 2.35 | 2.73 | 2.90 | 3.40 | 4.00 | 4.60 | 6.00 | 8.00 | 9.00 | 10.00 | 11.00 |
| Total Commodity Producing Sectors | 26.63 | 26.67 | 39.30 | 35.85 | 39.75 | 53.15 | 59.88 | 56.46 | 66.71 | 59.68 | 72.44 | 58.57 | 68.60 | 80.25 | 84.80 | 93.50 | 102.80 | 131.10 | 158.00 | 172.00 | 193.00 | 224.00 |
| 5. Transport | 10.70 | 11.12 | 12.64 | 12.53 | 12.77 | 12.03 | 12.60 | 14.42 | 14.84 | 14.55 | 16.01 | 15.91 | 16.20 | 18.09 | 17.50 | 17.90 | 18.50 | 28.00 | 31.00 | 35.00 | 39.00 | 43.00 |
| 6. Wholesale & Retail Trade | 18.01 | 19.57 | 24.28 | 23.63 | 26.43 | 28.01 | 31.43 | 28.92 | 39.08 | 29.07 | 38.36 | 38.00 | 39.00 | 42.80 | 44.00 | 47.10 | 50.70 | 60.00 | 64.00 | 69.00 | 74.00 | 78.00 |
| 7. Banking | 0.80 | 0.87 | 1.27 | 1.46 | 1.35 | 1.51 | 2.11 | 2.77 | 3.40 | 2.97 | 4.20 | 4.19 | 3.37 | 3.38 | 4.90 | 5.20 | 5.60 | 7.00 | 8.00 | 9.00 | 10.00 | 11.00 |
| 8. Ownership of Dwellings | 6.30 | 7.13 | 8.01 | 8.58 | 9.39 | 9.93 | 10.69 | 11.20 | 11.90 | 12.33 | 12.78 | 13.61 | 14.41 | 15.19 | 16.00 | 17.20 | 18.60 | 19.00 | 21.00 | 24.00 | 27.00 | 30.00 |
| 9. Public Admin. & Defence | 14.95 | 15.79 | 16.74 | 17.06 | 17.61 | 19.70 | 21.41 | 22.03 | 26.01 | 33.25 | 36.28 | 37.94 | 39.00 | 44.00 | 42.70 | 46.30 | 50.00 | 59.00 | 63.00 | 68.00 | 72.00 | 77.00 |
| 10.Other Services | 7.78 | 8.26 | 8.63 | 9.51 | 10.37 | 11.19 | 12.83 | 14.10 | 15.17 | 16.64 | 18.27 | 21.34 | 22.00 | 23.75 | 24.50 | 26.00 | 27.30 | 33.00 | 36.00 | 39.00 | 42.00 | 45.00 |
| Total Service Producing Sects. | 58.54 | 62.74 | 71.57 | 72.77 | 77.92 | 82.37 | 91.08 | 93.28 | 110.40 | 108.81 | 125.90 | 130.99 | 133.98 | 143.91 | 149.60 | 159.70 | 170.70 | 206.00 | 223.00 | 244.00 | 264.00 | 284.00 |
| GDP | 85.17 | 89.41 | 110.87 | 108.62 | 117.67 | 135.52 | 150.95 | 149.74 | 177.11 | 168.49 | 198.34 | 189.56 | 202.58 | 224.16 | 234.40 | 253.20 | 273.50 | 337.00 | 381.00 | 416.00 | 457.00 | 508.00 |

Source: (1) For the period 1959-1966, see the Hashemite Kingdom of Jordan, Dept. of Statistics, The National Accounts, 1967-1972, (Amman: Dept. of Statistics Press, May 1973) p. 71.
(2) For the period 1967-1975, see the National Planning Council, Three Year Development Plan, 1973-1975, p. 48.
(3) For the period 1976-1980, see the National Planning Council, Five Year Development Plan, 1976-1980, p. 54.

Appendix 4.1

## Bank Clearings and Demand Deposits in Jordan, 1965-1976

(In millions of JD)

| Years | Total Clearings | Adjusted Figures* | Demand Deposits |
|---|---|---|---|
| 1965 | 99.68 | 149.52 | 24.50 |
| 1966 | 144.24 | 216.36 | 30.94 |
| 1967 | 154.52 | 231.78 | 31.59 |
| 1968 | 153.29 | 229.93 | 30.80 |
| 1969 | 169.45 | 254.17 | 32.44 |
| 1970 | 161.58 | 242.37 | 30.80 |
| 1971 | 163.76 | 245.64 | 30.43 |
| 1972 | 204.70 | 307.05 | 39.44 |
| 1973 | 280.14 | 420.19 | 47.44 |
| 1974 | 399.28 | 598.92 | 62.97 |
| 1975 | 690.59 | 1,035.89 | 92.51 |
| 1976 | 1,186.32 | 1,779.48 | 123.39 |

Source: (i) International Monetary Fund, IFS, (1973 Supplement).

(2) IMF., IFS., (Dec. 1977)

(3) " " (Dec. 1978)

* Adjusted Figures for each year = Total Clearings + 50%

Appendix 4.2 Demand Deposits and Bank Debits in Selected Developing and Developed Countries, 1965-1976

| | Iraq (millions of Dinars) | | Libya (millions of Dinars) | | Ghana (millions of new Cedis) | | U.S.A. (billions of dollars) | | Germany (billions of deutschemarks) | | Japan (billions of yen) | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Demand Deposit | Bank Debits | Demand Deposit | Bank Debits | Demand Deposit | Bank Debits | Demand Deposit | Bank Debits | Demand Deposit | Bank Debits | Demand Deposit | Bank Debits |
| 1965 | 31.0 | 782.4 | 23.1 | 638.4 | 121.6 | 2,874.0 | 138.9 | 5,134.8 | 42.9 | 2,165.4 | 8,032 | 325,896 |
| 1966 | 33.6 | 841.2 | 29.0 | 862.8 | 130.8 | 2,948.4 | 140.8 | 5,942.4 | 43.0 | 2,386.8 | 9,127 | 368,604 |
| 1967 | 35.2 | 859.2 | 32.6 | 1,034.6 | 120.8 | 2,600.4 | 152.2 | 6,679.2 | 49.7 | 2,515.2 | 10,255 | 429,888 |
| 1968 | 38.5 | 926.4 | 45.0 | 1,450.8 | 132.6 | 3,050.4 | 165.2 | 7,988.4 | 55.4 | 3,049.2 | 11,560 | 513,180 |
| 1969 | 42.8 | 937.2 | 47.9 | 1,810.8 | 137.5 | 2,388.0 | 169.7 | 9,021.6 | 58.6 | 3,662.4 | 13,963 | 611,640 |
| 1970 | 43.5 | 884.4 | 76.5 | 1,384.4 | 150.9 | 3,745.2 | 175.5 | 10,143.6 | 65.4 | 4,466.4 | 16,261 | 759,156 |
| 1971 | 46.4 | 708.0 | 141.3 | 1,695.8 | 159.2 | 4,014.0 | 186.7 | 11,844.0 | 75.0 | 4,798.8 | 21,735 | 861,228 |
| 1972 | 50.5 | 748.8 | 153.3 | 2,451.0 | 219.9 | 4,602.0 | 205.1 | 13,585.2 | 85.6 | 5,221.2 | 26,820 | 1,030,092 |
| 1973 | 64.3 | 925.2 | 178.4 | 3,274.4 | 290.9 | 5,121.6 | 216.4 | 17,138.4 | 85.0 | 5,941.2 | 31,198 | 1,379,424 |
| 1974 | 92.7 | 1,302.0 | 311.1 | 6,029.7 | 320.0 | 7,203.6 | 218.8 | 20,978.4 | 97.0 | 6,567.6 | 34,220 | 1,718,664 |
| 1975 | 149.5 | 2,041.2 | 335.7 | 6,572.8 | 494.6 | 8,623.2 | 228.0 | 22,999.2 | 112.9 | 7,261.2 | 38,370 | 2,048,964 |
| 1976 | 184.9 | 2,695.2 | 492.9 | 7,109.6 | 679.0 | 10,909.2 | 237.6 | 26,696.4 | 115.5 | 8,023.2 | 43,321 | 2,196,240 |

Source: (1) International Monetary Fund, IFS., (1973 Supplement) (2) IMF., IFS., (Dec. 1977)

(3) IMF., IFS., (Dec. 1978)

Appendix 4.3 The Growth in the Network of Bank Branches, 1964-1976

| | Bank Nationality | Year of Establishment | 1964 | | | 1967 | | | East Bank of Jordan* | | | | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | 1968 | | 1969 | | 1970 | | 1971 | | 1972 | | 1973 | | 1974 | | 1975 | | 1976 | |
| | | | East Bank | West Bank | Total | East Bank | West Bank | Total | Amman & Suburbs | Total | Amman & Suburbs | Total | Amman & Suburbs | Total | Amman & Suburbs | Total | Amman & Suburbs | Total | Amman & Suburbs | Total | Amman & Suburbs | Total | Amman & Suburbs | Total | Amman & Suburbs | Total |
| A. Jordanian Banks | 1 The Arab Bank Ltd. | 1934 | 2 | 6 | 8 | 4 | 6 | 10 | 2 | 5 | 2 | 5 | 3 | 6 | 3 | 6 | 4 | 7 | 6 | 9 | 6 | 9 | 6 | 9 | n.a. | 9 |
| | 2 Jordan Nat. Bank | 1955 | 4 | 3 | 7 | 5 | 3 | 8 | 1 | 5 | 1 | 5 | 1 | 5 | 1 | 5 | 2 | 7 | 3 | 11 | 4 | 13 | 4 | 13 | n.a. | 13 |
| | 3 Bank of Jordan Ltd. | 1960 | 4 | 2 | 6 | 10 | 3 | 13 | 2 | 10 | 2 | 10 | 3 | 11 | 3 | 11 | 4 | 12 | 4 | 14 | 5 | 16 | 5 | 16 | n.a. | 17 |
| | 4 Cairo-Amman Bank | 1960 | 4 | 5 | 9 | 3 | 5 | 8 | 2 | 3 | 2 | 3 | 2 | 3 | 2 | 3 | 2 | 3 | 2 | 3 | 7 | 9 | 7 | 9 | n.a. | 10 |
| | Total Jordanian Bank Branches | | 14 | 16 | 30 | 22 | 17 | 39 | 7 | 23 | 7 | 23 | 9 | 25 | 9 | 25 | 12 | 29 | 15 | 37 | 22 | 47 | 22 | 47 | n.a. | 49 |
| B. Arab Banks | 5 Arab Land Bank (Egyptian) | 1951 | 3 | 3 | 6 | 4 | 4 | 8 | 1 | 4 | 1 | 4 | 1 | 4 | 1 | 4 | 1 | 4 | 2 | 6 | 2 | 6 | 3 | 7 | n.a. | 7 |
| | 6 Rafidain Bank (Iraqi) | 1957 | 1 | - | 1 | 1 | - | 1 | 1 | 1 | 1 | 1 | 1 | 2 | 1 | 2 | 1 | 2 | 1 | 2 | 1 | 2 | 1 | 2 | n.a. | 2 |
| | 7 Bank Al-Mashrek (Lebanese) | 1969 | - | - | - | - | - | - | - | - | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 2 | 2 | 2 | 2 | 2 | 2 | n.a. | 2 |
| | Total Arab Bank Branches | | 4 | 3 | 7 | 5 | 4 | 9 | 2 | 5 | 3 | 6 | 3 | 7 | 3 | 7 | 3 | 7 | 5 | 10 | 5 | 10 | 6 | 11 | n.a. | 11 |
| C. Foreign Banks | 8 Grindlays Bank Ltd. (British) | 1925 | 4 | - | 4 | 4 | 5 | 9 | 1 | 4 | 2 | 5 | 3 | 6 | 3 | 6 | 3 | 6 | 3 | 6 | 7 | 11 | 8 | 12 | n.a. | 13 |
| | 9 Brit. Bank for the Middle East (Brit) | 1949 | 1 | 1 | 2 | 1 | 1 | 2 | 1 | 1 | 1 | 1 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 3 | 3 | 4 | 4 | n.a. | 4 |
| | 10 First Nat. City Bank (American) | 1974 | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | 1 | 1 | 1 | 1 | n.a. | 2 |
| | 11 Chase Manhatten Bank (American) | 1975 | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | 1 | 1 | n.a. | 1 |
| | 12 Bank of Credit & Commerce Internat. (Luxembourg) | 1975 | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | - | 1 | 1 | n.a. | 1 |
| | Total Foreign Bank Branches | | 5 | 1 | 6 | 5 | 6 | 11 | 2 | 5 | 3 | 6 | 5 | 8 | 5 | 8 | 5 | 8 | 5 | 8 | 11 | 15 | 15 | 19 | n.a. | 21 |
| | Total Bank Branches (A) + (B) + (C) | | 23 | 20 | 43 | 32 | 27 | 59 | 11 | 33 | 13 | 35 | 17 | 40 | 17 | 40 | 20 | 44 | 25 | 55 | 38 | 72 | 42 | 77 | n.a. | 81 |

Source: Central Bank of Jordan, Banking Control Dept. (unpublished data)

* Since bank branches in the West Bank were closed in 1967, figures after thisyear include only the East Bank.

Appendix 4.4

## Industrial Origin of Gross Domestic Product, 1964-1976*

(in millions of JD)

| Sector | 1964 | | 1965 | | 1966 | | 1967 | | 1968 | | 1969 | | 1970 | | 1971 | | 1972 | | 1973 | | 1974 | | 1975 | | 1976 | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % |
| (1) Agriculture | 34.14 | 25.2 | 34.11 | 22.6 | 27.65 | 18.5 | 38.74 | 21.9 | 27.53 | 16.3 | 36.34 | 18.3 | 28.66 | 15.1 | 37.81 | 18.7 | 42.45 | 18.9 | 31.92 | 13.3 | 54.48 | 17.7 | 26.00 | 10.0 | 37.30 | 11.1 |
| (2) Mining & Industry | 12.53 | 9.2 | 16.22 | 10.7 | 17.27 | 11.5 | 17.50 | 9.9 | 20.05 | 11.9 | 23.12 | 11.6 | 19.77 | 10.4 | 20.56 | 10.1 | 25.23 | 11.3 | 28.60 | 11.9 | 49.11 | 15.9 | 48.80 | 18.1 | 61.00 | 18.2 |
| (3) Construction | 5.45 | 4.0 | 7.87 | 5.2 | 9.28 | 6.2 | 8.69 | 4.9 | 9.83 | 5.8 | 10.89 | 5.5 | 7.79 | 4.1 | 7.50 | 3.7 | 9.67 | 4.3 | 15.30 | 6.5 | 17.00 | 5.5 | 16.10 | 6.0 | 23.30 | 6.9 |
| (4) Electricity & Water | 1.03 | 0.8 | 1.68 | 1.1 | 2.26 | 1.5 | 1.78 | 1.0 | 2.27 | 1.3 | 2.09 | 1.1 | 2.35 | 1.2 | 2.73 | 1.3 | 2.90 | 1.3 | 3.47 | 1.5 | 3.66 | 1.2 | 3.10 | 0.8 | 3.60 | 1.1 |
| Total Material Producing Sectors | 53.15 | 39.2 | 59.88 | 39.6 | 56.46 | 37.7 | 66.71 | 37.7 | 59.68 | 35.3 | 72.44 | 36.5 | 58.57 | 30.8 | 68.60 | 33.8 | 80.25 | 35.8 | 79.29 | 33.2 | 124.25 | 40.3 | 94.00 | 34.9 | 125.20 | 37.3 |
| (5) Transport | 12.03 | 8.9 | 12.60 | 8.4 | 14.42 | 9.6 | 14.84 | 8.4 | 14.55 | 8.6 | 16.01 | 8.1 | 15.91 | 8.4 | 16.20 | 8.0 | 18.09 | 8.1 | 19.95 | 8.3 | 25.29 | 8.2 | 24.90 | 9.3 | 33.60 | 10.0 |
| (6) Wholesale & Retail Trd. | 28.01 | 20.7 | 31.43 | 20.8 | 28.92 | 19.3 | 39.08 | 22.1 | 29.07 | 17.3 | 38.36 | 19.3 | 38.00 | 20.0 | 39.00 | 19.3 | 42.50 | 18.9 | 45.00 | 18.8 | 52.00 | 16.9 | 43.90 | 16.3 | 50.50 | 15.0 |
| (7) Banking | 1.51 | 1.1 | 2.11 | 1.4 | 2.77 | 1.9 | 3.40 | 1.9 | 2.97 | 1.8 | 4.20 | 2.1 | 4.19 | 2.2 | 3.37 | 1.7 | 3.38 | 1.5 | 3.36 | 1.4 | 3.80 | 1.2 | 4.30 | 1.6 | 5.20 | 1.5 |
| (8) Ownership of Dwellings | 9.93 | 7.3 | 10.69 | 7.1 | 11.20 | 7.5 | 11.90 | 6.7 | 12.33 | 7.3 | 12.78 | 6.5 | 13.61 | 7.2 | 14.41 | 7.1 | 15.19 | 6.8 | 16.00 | 6.7 | 17.50 | 5.7 | 15.70 | 5.8 | 17.30 | 5.3 |
| (9) Public Admin. & Defence | 19.70 | 14.5 | 21.41 | 14.2 | 22.03 | 14.7 | 26.01 | 14.7 | 33.25 | 19.7 | 36.28 | 18.3 | 37.94 | 20.1 | 39.00 | 19.3 | 41.00 | 18.3 | 49.57 | 20.7 | 54.76 | 17.7 | 56.10 | 20.9 | 67.30 | 20.0 |
| (10)Other Services | 11.19 | 8.3 | 12.84 | 8.5 | 13.94 | 9.3 | 15.17 | 8.5 | 16.64 | 10.0 | 18.27 | 9.2 | 21.34 | 11.3 | 22.00 | 10.8 | 23.75 | 10.6 | 26.14 | 10.9 | 31.00 | 10.0 | 30.10 | 11.2 | 36.70 | 10.9 |
| Total Services Producing Sectors | 82.37 | 60.8 | 91.08 | 60.4 | 93.28 | 62.3 | 110.40 | 62.3 | 108.81 | 64.7 | 125.90 | 63.5 | 130.99 | 69.2 | 133.98 | 66.2 | 143.91 | 64.2 | 160.02 | 66.8 | 184.35 | 59.7 | 175.00 | 65.1 | 210.60 | 62.7 |
| GDP | 135.52 | 100.0 | 150.96 | 100.0 | 149.74 | 100.0 | 177.11 | 100.0 | 168.49 | 100.0 | 198.34 | 100.0 | 189.56 | 100.0 | 202.58 | 100.0 | 224.16 | 100.0 | 239.31 | 100.0 | 308.60 | 100.0 | 269.00 | 100.0 | 335.80 | 100.0 |

Source: (1) For data pertaining to the period 1964-1969, see Jordan Dept. of Statistics, The National Accounts, 1967-1972.
(2) For data pertaining to the period 1970-1974, see Jordan Dept. of Statistics, The National Account, 1970-1974.
(3) For data pertaining to the period 1975-1976, see Central Bank of Jordan, Fourteenth Annual Report, 1977.

* Figures pertaining to 1975 and 1976 are for the East Bank only.

Appendix 4.5

## Distribution of Bank Credit According to Sector, 1964 - 1977

(In millions of JD)

| Sector | 1964 | | 1965 | | 1966 | | 1967 | | 1968 | | 1969 | | 1970 | | 1971 | | 1972 | | 1973 | | 1974 | | 1975 | | 1976 | | 1977 | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % |
| Agriculture | 0.86 | 2.9 | 0.68 | 2.0 | 0.61 | 1.6 | 0.77 | 2.0 | 0.65 | 1.6 | 0.72 | 1.6 | 0.58 | 1.3 | 0.80 | 1.7 | 0.80 | 1.6 | 2.06 | 3.3 | 3.74 | 4.5 | 3.61 | 3.0 | 5.16 | 2.8 | 8.31 | 4.1 |
| Mining & Industry | 3.55 | 12.1 | 4.33 | 13.0 | 4.75 | 12.2 | 4.25 | 10.9 | 4.02 | 9.8 | 4.20 | 9.3 | 4.76 | 10.5 | 4.59 | 9.8 | 4.65 | 9.2 | 6.26 | 10.2 | 10.46 | 12.5 | 15.11 | 12.4 | 22.14 | 12.0 | 26.83 | 13.3 |
| Construction & Land Purchase | 2.24 | 7.7 | 2.45 | 7.4 | 3.27 | 8.4 | 5.02 | 12.9 | 6.09 | 14.9 | 7.10 | 15.7 | 11.23 | 24.6 | 10.51 | 22.4 | 10.67 | 21.1 | 14.44 | 23.4 | 18.84 | 22.4 | 26.28 | 21.6 | 30.86 | 16.8 | 33.83 | 16.8 |
| Transportation | 2.59 | 8.8 | 2.33 | 7.0 | 2.15 | 5.5 | 1.77 | 4.6 | 1.79 | 4.4 | 1.55 | 3.4 | 2.43 | 5.3 | 2.62 | 5.6 | 2.42 | 4.8 | 2.19 | 3.5 | 5.29 | 6.3 | 3.69 | 3.0 | 7.78 | 4.3 | 11.08 | 5.5 |
| General Commerce & Trade | 14.41 | 49.2 | 17.08 | 51.3 | 20.34 | 52.2 | 17.35 | 44.6 | 17.08 | 41.6 | 19.06 | 42.0 | 16.89 | 37.1 | 18.96 | 40.4 | 21.46 | 42.4 | 25.08 | 40.6 | 30.30 | 36.1 | 51.37 | 42.3 | 81.61 | 44.4 | 81.42 | 40.5 |
| Financial Institutions | 0.23 | 0.8 | 0.14 | 0.4 | 0.33 | 0.8 | 0.20 | 0.5 | 0.19 | 0.4 | 0.19 | 0.4 | 0.18 | 0.4 | 0.25 | 0.5 | 0.34 | 0.6 | 0.60 | 0.9 | 0.74 | 0.8 | 0.34 | 0.2 | 0.56 | 0.3 | 0.58 | 0.3 |
| Municipalities & Public Corps. | 1.61 | 5.6 | 2.06 | 6.2 | 2.58 | 6.6 | 2.92 | 7.5 | 3.68 | 9.0 | 2.94 | 6.5 | 2.83 | 6.2 | 3.03 | 6.5 | 3.60 | 7.1 | 3.67 | 5.9 | 5.05 | 6.1 | 7.18 | 5.9 | 8.09 | 4.4 | 6.91 | 3.4 |
| Tourism & Hotel | 0.81 | 2.7 | 0.95 | 2.9 | 0.98 | 2.5 | 1.10 | 2.8 | 1.00 | 2.4 | 1.00 | 2.2 | 0.98 | 2.1 | 0.89 | 1.9 | 0.92 | 1.8 | 1.38 | 2.2 | 1.53 | 1.8 | 1.78 | 1.6 | 2.52 | 1.4 | 3.42 | 1.7 |
| Professional & Private Indiv. | 1.46 | 5.0 | 1.70 | 5.1 | 2.25 | 5.8 | 2.14 | 5.5 | 2.46 | 6.0 | 3.07 | 6.7 | 4.14 | 9.1 | 3.28 | 6.9 | 3.90 | 7.8 | 4.56 | 7.4 | 5.47 | 6.5 | 7.40 | 6.2 | 11.37 | 6.2 | 13.08 | 6.6 |
| Other | 1.51 | 5.2 | 1.58 | 4.7 | 1.73 | 4.4 | 3.37 | 8.7 | 4.04 | 9.9 | 5.56 | 12.2 | 1.53 | 3.4 | 2.00 | 4.3 | 1.83 | 3.6 | 1.58 | 2.6 | 2.56 | 3.0 | 4.67 | 3.8 | 13.65 | 7.4 | 15.62 | 7.8 |
| Total Credit | 29.27 | 100.0 | 33.30 | 100.0 | 38.99 | 100.0 | 38.89 | 100.0 | 41.00 | 100.0 | 45.39 | 100.0 | 45.55 | 100.0 | 46.93 | 100.0 | 50.59 | 100.0 | 61.82 | 100.0 | 83.98 | 100.0 | 121.43 | 100.0 | 183.74 | 100.0 | 201.09 | 100.0 |

Source: (1) For data pertaining to the years 1964-1966, see the Central Bank of Jordan, The Annual Report, 1966.

(2) For data pertaining to the period 1967-1971, see the Central Bank of Jordan, Eighth Annual Report.

(3) For data pertaining to the period 1972-1976, see the Central Bank of Jordan, Monthly Statistical Bulletin, (August, 1977).

(4) For data pertaining to 1977, see the Central Bank of Jordan, Monthly Statistical Bulletin (December, 1978).

Appendix 8.1 Geographical Distribution of the Agricultural Credit Extended by the ACC, 1973 - 1977

(JD ,000)

| Area | 1973 | | 1974 | | 1975 | | 1976 | | 1977 | | Average % 1973-1977 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Value | % | Value | % | Value | % | Value | % | Value | % | |
| Amman | 0,561 | 30.4 | 0,572 | 26.9 | 0,869 | 27.2 | 0,706 | 25.3 | 0,448 | 18.9 | 25.5 |
| Salt | 0,248 | 13.3 | 0,355 | 16.6 | 0,721 | 22.6 | 0,790 | 28.2 | 0,771 | 32.5 | 22.6 |
| Irbid | 0,214 | 11.6 | 0,315 | 14.7 | 0,364 | 11.4 | 0,211 | 7.5 | 0,152 | 6.4 | 10.8 |
| Jerash | 0,052 | 2.8 | 0,084 | 3.9 | 0,150 | 4.7 | 0,054 | 1.9 | 0,101 | 4.4 | 3.5 |
| Wadi Yabis | 0,163 | 8.8 | 0,123 | 5.8 | 0,144 | 4.5 | 0,172 | 6.3 | 0,185 | 7.8 | 6.6 |
| Ramtha | 0,031 | 1.7 | 0,020 | 0.9 | 0,042 | 1.3 | 0,038 | 1.3 | 0,070 | 3.0 | 1.6 |
| Mafraq | 0,151 | 8.2 | 0,163 | 7.6 | 0,232 | 7.3 | 0,153 | 5.4 | 0,185 | 7.8 | 7.3 |
| Ajlun | 0,049 | 2.7 | 0,040 | 1.9 | 0,094 | 2.9 | 0,052 | 1.8 | 0,035 | 1.5 | 2.2 |
| Karak | 0,142 | 7.7 | 0,157 | 7.3 | 0,165 | 5.2 | 0,227 | 8.2 | 0,232 | 9.8 | 7.6 |
| Tafileh | 0,085 | 4.6 | 0,155 | 7.2 | 0,207 | 6.6 | 0,144 | 5.3 | 0,045 | 1.9 | 5.1 |
| Ma'an | 0,047 | 2.5 | 0,029 | 1.4 | 0,043 | 1.3 | 0,090 | 3.4 | 0,026 | 1.1 | 1.9 |
| Madaba | 0,102 | 5.5 | 0,126 | 5.9 | 0,160 | 5.0 | 0,153 | 5.4 | 0,116 | 4.9 | 5.3 |
| TOTAL | 1,844 | 100.0 | 2,139 | 100.0 | 3,190 | 100.0 | 2,792 | 100.0 | 2,367 | 100.0 | 100.0 |

Source: ACC, Annual Reports, 1973 - 1977.

Appendix 8.2 Geographical Distribution of Cooperative Societies, 1974-1977

| Area | 1974 | | 1975 | | 1976 | | 1977 | | Average Percentage 1974-1977 |
|---|---|---|---|---|---|---|---|---|---|
| | No. | % | No. | % | No. | % | No. | % | |
| Amman & Zerka | 103 | 41.3 | 119 | 46.8 | 144 | 48.8 | 139 | 46.0 | 45.7 |
| Salt | 14 | 5.6 | 15 | 5.9 | 15 | 5.1 | 18 | 6.0 | 5.6 |
| Jordan Valley | 33 | 13.3 | 22 | 8.7 | 26 | 8.8 | 25 | 8.2 | 9.8 |
| Irbid & Ajlon | 61 | 24.6 | 49 | 19.3 | 35 | 11.9 | 40 | 13.2 | 17.2 |
| Jerash & Mafraq | - | - | - | - | 6 | 2.0 | 6 | 2.0 | 1.0 |
| Ma'an & Madaba | 12 | 4.8 | 24 | 9.5 | 39 | 13.2 | 43 | 14.3 | 10.5 |
| Karak & Tafileh | 26 | 10.4 | 25 | 9.8 | 30 | 10.2 | 31 | 10.3 | 10.2 |
| TOTAL | 249 | 100.0 | 254 | 100.0 | 295 | 100.0 | 302 | 100.0 | 100.0 |

Source: JCO, Annual Reports, 1974 - 1977.

Appendix 8.3 Geographical Distribution of Loans Approved by the Small-Scale Industry & Handicrafts Fund During 1977

| Loans | Amman | | Zerka | | Russeifa & Wadi Es-Seer | | Salt & Suweileh | | Mafraq & Ramtha | | Ajlun & Irbid | | Ma'an & Sa'hab | | Fouhes & Madaba | | Karak & Tafila | | Total | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % |
| No. of Loans | 37 | 37.0 | 12 | 12.0 | 8 | 8.0 | 4 | 4.0 | 4 | 4.0 | 16 | 16.0 | 2 | 2.0 | 12 | 12.0 | 5 | 5.0 | 100 | 100.0 |
| Amounts (JD) | 63950 | 37.8 | 18500 | 10.9 | 15600 | 9.2 | 7700 | 4.6 | 7300 | 4.3 | 27550 | 16.3 | 2700 | 1.6 | 16700 | 9.9 | 9200 | 5.4 | 169200 | 100.0 |

Source: IDB, Annual Report, 1977, p. 22.

Appendix 8.4 Sectoral Distribution of Loans Approved by the Small-Scale Industry & Handicrafts Fund During 1977

| Loans | Carpentry | | Garments & Knitting | | Concrete Products & Stone Cutting | | Printing & Photo-graphy | | Tire Tubes Repair | | Leather Bags | | Blacksmith | | Aluminium Works | | Confect-ionary & Bakeries | | Total | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % | Abs. | % |
| No. of Loans | 41 | 41.0 | 14 | 14.0 | 18 | 18.0 | 3 | 3.0 | 6 | 6.0 | 1 | 1.0 | 9 | 9.0 | 2 | 2.0 | 6 | 6.0 | 100 | 100.0 |
| Amounts (JD) | 78450 | 46.4 | 17750 | 10.5 | 30050 | 17.8 | 4800 | 2.8 | 9400 | 5.5 | 2000 | 1.2 | 12250 | 7.2 | 4000 | 2.4 | 10500 | 6.2 | 169200 | 100.0 |

Source: IDB, Annual Report, 1977, p. 23.

Appendix 8.5 Network of the H.B. Branches

1974 - 1977

| Year | Number of Accounts | Number of Branches | | | | | |
|---|---|---|---|---|---|---|---|
| | | Amman | | Other Areas | | Total | |
| | | Absolute | % | Absolute | % | Absolute | % |
| 1974 | 2532 | 3 | 60.0 | 2 | 40.0 | 5 | 100.0 |
| 1975 | 9634 | 3 | 37.5 | 5 | 62.5 | 8 | 100.0 |
| 1976 | 18238 | 3 | 23.1 | 10 | 76.9 | 13 | 100.0 |
| 1977 | 37522 | 4 | 26.7 | 11 | 73.3 | 15 | 100.0 |

Source: Housing Bank, Annual Reports, 1974, 75, 76 and 1977.

Appendix 8.6 Geographical Distribution of the Housing Credit Extended by the HB, 1974 - 1977

(JD ,000)

| Area | 1974 | | 1975 | | 1976 | | 1977 | | Average Percentage 1974-1977 |
|---|---|---|---|---|---|---|---|---|---|
| | Amount | % | Amount | % | Amount | % | Amount | % | |
| Amman | 1259 | 68.3 | 6453 | 75.2 | 23099 | 69.7 | 10314 | 66.9 | 70.0 |
| Irbid | 155 | 8.4 | 666 | 7.8 | 1960 | 5.9 | 1378 | 9.0 | 7.8 |
| Salt | 134 | 7.3 | 181 | 2.1 | 257 | 0.8 | 399 | 2.6 | 3.2 |
| Karak | 74 | 4.0 | 128 | 1.5 | 53 | 0.2 | 214 | 1.4 | 1.8 |
| Zerka | 80 | 4.3 | 596 | 6.9 | 3969 | 12.0 | 973 | 6.3 | 7.4 |
| Madaba | 43 | 2.3 | 162 | 1.9 | 235 | 0.7 | 539 | 3.5 | 2.1 |
| Fuhais | - | - | - | - | 139 | 0.4 | 449 | 2.9 | 0.8 |
| Mafraq | 34 | 1.9 | 129 | 1.5 | 301 | 0.9 | 170 | 1.1 | 1.3 |
| Tafileh | 24 | 1.3 | 27 | 0.3 | 5 | - | 100 | 0.7 | 0.6 |
| Ajlun | 14 | 0.8 | 55 | 0.6 | 118 | 0.4 | 121 | 0.8 | 0.6 |
| Jerash | 15 | 0.8 | 48 | 0.6 | 39 | 0.1 | 201 | 1.3 | 0.7 |
| Ma'an | 4 | 0.2 | 12 | 0.1 | 4 | - | 80 | 0.5 | 0.2 |
| Ramtha | 7 | 0.4 | 31 | 0.4 | 3 | - | 157 | 1.0 | 0.5 |
| Aquaba | - | - | 90 | 1.1 | 2551 | 7.7 | 311 | 2.0 | 2.7 |
| Others | - | - | - | - | 389 | 1.2 | 5 | - | 0.3 |
| | 1843 | 100.0 | 8578 | 100.0 | 33122 | 100.0 | 15411 | 100.0 | 100.0 |

Source: Housing Bank, Report of the Board of Directors for Financial Year Ending 31/12/77 (Amman), Table (6).

## Appendix 10.1

## Return on Industrial Shares in a Sample of 12 Jordanian Shareholding Companies in 1975*

| Company | Return on Capital (Distributed profits as % of Net Worth) |
|---|---|
| 1. Jordan Petroleum Refinery | 8.8 |
| 2. Jordan Phosphate Mines | 10.1 |
| 3. Jordan Cement Factories | 5.2 |
| 4. The Arab Pharmaceutical Mfg. Co. | 40.0 |
| 5. Jordan Brewery Company | 8.3 |
| 6. Jordan Paper Factories | 10.3 |
| 7. Jordan Dyeing Company | 18.2 |
| 8. Jordan Minerals Research | 12.5 |
| 9. Industrial, Commercial & Agr. Co. | 9.0 |
| 10. Jordan Dairy | 12.0 |
| 11. Jordan Worsted Mills | 9.3 |
| 12. Jordan Woollen Shareholding Industries | 17.0 |
| Average Return | 13.4 |

Source: Annual Reports of the Above Mentioned Companies for 1975.

* Subscribed capital of these companies accounted for about JD 55 million, which represented 40% of the subscribed capital of total companies listed on the Amman Financial Market. (Source: AFM, unpublished Figures).

## Appendix 11.1 Nominal and Real Rates of Interest on Selected Financial Assets, 1955 - 1977

(% per annum)

| Year | Nominal Rates (1) | | | Rate of Inflation (2) | Real Rates (3) = (1 - 2) | | |
|---|---|---|---|---|---|---|---|
| | Currency in Hand | Bank Deposits * | Govt. Bonds ** | | Currency in Hand | Bank Deposits | Govt. Bonds |
| 1955 | none | 4.0 | - | 1.0 | - 1.0 | 3.0 | - |
| 1956 | none | 4.0 | - | 1.0 | - 1.0 | 3.0 | - |
| 1957 | none | 4.0 | - | 1.0 | - 1.0 | 3.0 | - |
| 1958 | none | 4.0 | - | 1.0 | - 1.0 | 3.0 | - |
| 1959 | none | 4.0 | - | 1.0 | - 1.0 | 3.0 | - |
| 1960 | none | 4.0 | - | 1.0 | - 1.0 | 3.0 | - |
| 1961 | none | 4.0 | - | 1.9 | - 1.9 | 2.1 | - |
| 1962 | none | 4.0 | - | 1.9 | - 1.9 | 2.1 | - |
| 1963 | none | 4.0 | - | 1.8 | - 1.9 | 2.2 | - |
| 1964 | none | 4.0 | - | 1.8 | - 1.8 | 2.2 | - |
| 1965 | none | 4.0 | - | 1.8 | - 1.8 | 2.2 | - |
| 1966 | none | 4.0 | - | 1.7 | - 1.7 | 2.3 | - |
| 1967 | none | 4.0 | - | 1.7 | - 1.7 | 2.3 | - |
| 1968 | none | 4.0 | - | 0.8 | - 0.8 | 3.2 | - |
| 1969 | none | 4.0 | - | 7.8 | - 7.8 | - 3.8 | - |
| 1970 | none | 4.0 | - | 6.1 | - 6.1 | - 2.1 | - |
| 1971 | none | 4.0 | 8.0 | 5.7 | - 5.7 | - 1.7 | 2.3 |
| 1972 | none | 4.9 | 8.0 | 7.7 | - 7.7 | - 2.8 | 0.3 |
| 1973 | none | 4.9 | 8.0 | 11.1 | -11.1 | - 6.2 | - 3.1 |
| 1974 | none | 4.9 | 8.0 | 19.4 | -19.4 | -14.5 | -11.4 |
| 1975 | none | 4.9 | 8.0 | 11.9 | -11.9 | - 7.0 | - 3.9 |
| 1976 | none | 5.6 | 8.0 | 15.3 | -15.3 | - 9.7 | - 7.3 |
| 1977 | none | 5.8 | 8.0 | 14.5 | -14.5 | - 8.7 | - 6.5 |
| Average 55-66 | none | 4.0 | - | 1.4 | - 1.4 | 2.6 | - |
| Average 67-72 | none | 4.2 | 8.0 | 4.9 | - 4.9 | - 0.7 | 1.3 |
| Average 73-77 | none | 5.2 | 8.0 | 14.4 | -14.4 | - 9.2 | - 6.4 |

Source: Official Published Statistics on interest rates are only available since 1972. Prior to this, data were obtained from: Y. Sukar, The Structure of Interest Rates in Jordan, (Central Bank of Jordan's publications, Nov. 1974)

* Average interest rate paid on different types of bank deposits.

** Govt. bonds were issued only in 1971. The above rates are applicable to those held by individuals. Commercial banks' holdings of such securities yielded 6.25% per annum.

## Appendix 11.2

## Term Structure of Deposit and Lending Rates of Interest in Jordan as of December 31, 1977

(% per annum)

| Type | Interest Rate |
|---|---|
| 1. Central Bank of Jordan | |
| Bank Rate | 5.00 |
| Long-term loans | 4.00 |
| Short-term loans | 5.00 |
| Three Months' time Deposits | 4.00 |
| Deposits subject to Notice | 3.00 |
| 2. Commercial Banks | |
| Overdraft | 9.00 |
| Loans | 9.00 |
| Demand Deposits | 5.60 |
| Saving Deposits | 5.50 |
| Time Deposits | 6.10 |
| 3. Specialised Credit Institutions | |
| 3.1 Agricultural Credit Corporation | 6.00 |
| 3.2 Industrial Development Bank | 8.00 |
| 3.3 Housing Corporation | 5.00 |
| 3.4 Jordan Co-operative Organisation | 6.75 |
| 3.5 Municipal and Village Loan Fund | |
| Municipal | 5.50 |
| Village | 4.50 |
| 3.6 Housing Bank | |
| Individual loans | 8.50 |
| Commercial loans | 9.00 |
| Co-operative loans | 8.50 |
| Demand Deposits | 5.25 |
| Saving Deposits | 5.00 |
| Time Deposits | 5.75 |
| 4. Govt. Debt Instruments | |
| Treasury Bills | 4.91 |
| Development Bonds held by the Public | 8.00 |
| Development Bonds held by banks | 6.25 |

Source: Central Bank of Jordan, Monthly Statistical Bulletin (December 1978)